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THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

Part 4

WASHINGTON, DC—FEBRUARY 6, 1986
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THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

THURSDAY, FEBRUARY 6, 1968

U.S. Senate,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m., in room 428A, Russell Senate Office Building, Hon. Lowell Weicker, Jr. (chairman of the committee) presiding.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS

The Chairman. The committee will come to order.

The Senate Committee on Small Business has advocated in recent years, through hearings and legislation, the inclusion of provisions in the Federal Tax Code favorable to small businesses, including those which help small firms to attract and retain capital, promote capital investment, increase productivity, and enhance private sector job creation.

I am going to submit the rest of my statement for the record.

I would say only that clearly the time schedule of tax reform in the Senate is such that by the time it comes into position for serious consideration there probably would not be any time to hold hearings and get the views of the small business community. I figure that schedule probably to be, if indeed any legislation clears the Finance Committee, it probably would be summertime before it would hit the floor. Either there will be a great rush to get it through before the elections or it will wait until after the elections.

In any event, I thought it advisable to obtain the viewpoints of the small business community on what has been talked about so far, either what has been passed so far insofar as the House is concerned or what has been talked about since the House passed its legislation.

This hearing is of value to the Senate in that we will know how these various matters impact on small business and have those views in a timely fashion, so that if adjustments need to be made on the legislation on the floor, we will be able to do so.

I would appreciate it, since we have a great number of witnesses today, that all witnesses keep their comments to the 5 minutes which has been indicated by counsel. All statements in their entirety will be included in the record. Then if questions are raised during the course of the testimony, it will give us a chance to ask those questions and get responses.

[The prepared statements of Senators Weicker and Pressler follows:]

OPENING STATEMENT OF SENATOR LOWELL WEICKER, JR.
AT HEARING ON
IMPACT OF TAX REFORM ON SMALL BUSINESS

FEBRUARY 6, 1986

THE SENATE COMMITTEE ON SMALL BUSINESS HAS ADVOCATED IN RECENT YEARS, THROUGH HEARINGS AND LEGISLATION, THE INCLUSION OF PROVISIONS IN THE FEDERAL TAX CODE FAVORABLE TO SMALL BUSINESSES -- INCLUDING THOSE WHICH HELP SMALL FIRMS TO ATTRACT AND RETAIN CAPITAL, PROMOTE CAPITAL INVESTMENT, INCREASE PRODUCTIVITY, AND ENHANCE PRIVATE SECTOR JOB CREATION.

SINCE PRESIDENT REAGAN FIRST UNVEILED THE CONCEPT OF SWEEPING TAX REFORM IN 1984, AND SPECIFIC REFORM BILLS BEGAN TO EMERGE IN CONGRESS, SENATOR BUMPERS AND I, ALONG WITH OTHER COMMITTEE MEMBERS, HAVE BEEN CONCERNED THAT THIS CORE OF CAREFULLY CRAFTED TAX INCENTIVES FAVORABLE TO SMALL BUSINESS MIGHT UNRAVEL IN THE EVENT OF A MAJOR TAX CODE OVERHAUL. WITH THIS IN MIND, THE COMMITTEE HELD A COMPREHENSIVE SERIES OF 13 FIELD HEARINGS DURING 1985 IN ORDER TO EXAMINE THE IMPACT OF TAX REFORM ON SMALL BUSINESS, AND TO DETERMINE HOW ENTREPRENEURS AROUND THE COUNTRY BELIEVE THEY WOULD FARE UNDER THE PROPOSED CHANGES. THE COMMITTEE STAFF HAS PREPARED A DETAILED REPORT, AVAILABLE HERE TODAY, WHICH PROVIDES AN OVERVIEW OF THE SITUATION AND A SUMMARY OF THOSE HEARINGS.

THE TESTIMONY THE COMMITTEE WILL RECEIVE TODAY WILL URGE US TO RETAIN CERTAIN KEY INVESTMENT/CAPITAL FORMATION INCENTIVES ALREADY IN THE TAX CODE. IF THESE TAX PREFERENCES ARE KEPT, THEN ADJUSTMENTS WILL NEED TO BE MADE OR ADDITIONAL SOURCES MUST BE FOUND IN ORDER TO KEEP THE TAX REFORM BILL "REVENUE NEUTRAL."

IT IS AT THIS POINT I RAISE TO THE WITNESSES A CRITICAL QUESTION. IF CONGRESS DECIDES TO PASS A NEW TAX, LETS SAY AN ENERGY TAX, SHOULD THOSE REVENUES GO TO REDUCE THE DEFICIT OR BE APPLIED TO A TAX REFORM BILL SO THAT BUSINESS INCENTIVES CAN BE MAINTAINED AND THE BILL WILL STAY REVENUE NEUTRAL? OR STATED DIFFERENTLY, IS DEFICIT REDUCTION OR TAX REFORM A HIGHER PRIORITY FOR SMALL BUSINESS?

I LOOK FORWARD TO LEARNING THE VIEWS OF THOSE TESTIFYING TODAY, AS THEY WILL BECOME PART OF THE SMALL BUSINESS VIEWPOINT ADVANCED BY THE COMMITTEE DURING THE TAX REFORM DEBATE.

OPENING STATEMENT BY SENATOR LARRY PRESSLER SENATE SMALL BUSINESS COMMITTEE HEARING ON THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

FEBRUARY 6, 1986

I WOULD LIKE TO BEGIN BY COMMENDING THE CHAIRMAN FOR CALLING THIS HEARING. IT IS APPROPRIATE THAT WE CULMINATE THIS COMMITTEE'S EFFORTS IN CONSIDERING THE IMPACT OF TAX REFORM ON THE SMALL BUSINESS COMMUNITY AS THE SENATE FINANCE COMMITTEE PREPARES TO BEGIN DRAFTING ITS PROPOSAL TO REFORM THIS NATION'S TAX CODE.

ONE YEAR AGO, I CHAIRED HEARINGS OF THIS COMMITTEE IN SIOUX FALLS, HURON AND RAPID CITY, SOUTH DAKOTA WHICH EXPLORED THIS ISSUE. MUCH HAS CHANGED SINCE THAT TIME. THE PRESIDENT HAS OFFERED CONGRESS HIS PLAN FOR TAX REFORM. THE HOUSE OF REPRESENTATIVES HAS PASSED A COMPREHENSIVE TAX BILL. INTERESTINGLY ENOUGH HOWEVER, MANY OF THE CONCERNS RAISED BY THE SMALL BUSINESS PERSONS, FARMERS AND RANCHERS OF SOUTH DAKOTA LAST FEBRUARY REMAIN VALID.

I AM SURE MANY OF THE COMMON THREADS WHICH RAN THROUGH THE TESTIMONY GIVEN TO THIS COMMITTEE DURING THE SOUTH DAKOTA HEARINGS WILL WIND THEIR WAY THROUGH TODAY'S TESTIMONY. CONCERNS OVER THE TREATMENT OF CAPITAL GAINS, DEPRECIATION, AND EMPLOYEE FRINGE BENEFITS, AS WELL AS, THE FUTURE OF THE INVESTMENT TAX CREDIT, AND TAX EXEMPT GOVERNMENT BONDS WILL LIKELY BE ADDRESSED TODAY. THESE CONCERNS, WHILE ALTERED SOMEWHAT BY THE CONTINUED EVOLUTION OF TAX REFORM, ARE AS REAL TODAY AS THEY WERE LAST FEBRUARY.

ADDITIONALLY, I BELIEVE IT IS IMPORTANT TO CONSIDER WHETHER THE PROPOSALS TO CHANGE OUR TAX CODE TRULY REPRESENT TAX REFORM. TO ACHIEVE REAL REFORM AS ENVISIONED BY MOST AMERICANS, WE MUST DISCOVER HOW COMPLETELY PROPOSALS MEET FOUR VITALLY IMPORTANT TAX

REFORM OBJECTIVES. FIRST, IS IT EQUITABLE? THAT IS, WOULD THE PROPOSAL TAX TWO INDIVIDUALS OR BUSINESSES WITH SIMILAR INCOMES AT A SIMILAR RATE? SECOND, IS THE PROPOSAL NEUTRAL IN ITS TREATMENT OF BUSINESSES IN VARIOUS INDUSTRIES? THAT IS, HOW DOES THE TAX TREATMENT OF A FARMER COMPARE WITH THAT OF AN INSURANCE AGENT WITH SIMILAR INCOME?

THIRD, DOES THE PROPOSAL TRULY SIMPLIFY THE TAX CODE? FINALLY, DOES THE PROPOSAL OFFER STABILITY? OR WILL IT NEED TO BE MODIFIED FURTHER? IN THE PAST TEN (10) YEARS, CONGRESS HAS PASSED SEVEN (7) MAJOR TAX BILLS. THIS ALMOST YEARLY REFORM ONLY ADDS TO THE CONFUSION AND MISTRUST THIS COUNTRY'S CITIZENS ALREADY FEEL TOWARD OUR SYSTEM OF TAXATION.

MANY OF THE SOUTH DAKOTA WITNESSES WERE SKEPTICAL OF THE ABILITIES OF CONGRESS TO SIMPLIFY ANYTHING, LET ALONE THE TAX CODE. THIS ATTITUDE WAS APTLY SUMMED UP BY WILLIAM ANDERSON, PRESIDENT OF ANDERSON FURNITURE OF HURON, SOUTH DAKOTA WHO STATED: "ALTHOUGH ALL OF THE PROPOSALS HERE HAVE SOME MERIT, IT SEEMS THAT THE UNDERLYING REASONS FOR THESE CHANGES MAY HAVE BEEN IGNORED OR FORGOTTEN BY THE WRITERS OF THEM...A REASONABLE SET OF INCOME TAX LAWS WHICH ARE EQUITABLE, EASY TO UNDERSTAND, AND PROGRESSIVE TO OUR ECONOMY."

AS A RESULT OF THIS SKEPTICISM, WITNESSES IN EACH OF THE THREE HEARINGS SUGGESTED THAT THE BEST WAY TO TRULY SIMPLIFY THE TAX CODE MIGHT BE TO PLACE A MORATORIUM ON FURTHER TAX BILLS UNTIL BUSINESSES AND INDIVIDUALS HAVE HAD AN OPPORTUNITY TO MEASURE THE COMPLETE IMPACT OF PREVIOUS TAX CHANGES. A CHANCE TO GET USED TO THE "RULES OF THE GAME" IF YOU WILL. IN REVIEWING THE STAFF REPORT SUMMARIZING THE COMMITTEE'S FIELD HEARINGS IN PREPARATION FOR TODAY'S HEARING, I

FOUND THAT THIS SENTIMENT WAS EXPRESSED BY SMALL BUSINESS INDIVIDUALS FROM MANY OTHER STATES AS WELL.

IN CONCLUSION, I THINK THAT IN CONSIDERING YET ANOTHER REVISION OF OUR TAX CODE, MEMBERS OF CONGRESS MUST TAKE A HARD LOOK AT WHETHER WE ARE ACHIEVING MEANINGFUL REFORM OR IF WE ARE SIMPLY ENGAGED IN CHANGE FOR THE SAKE OF CHANGE. IF WE ARE NOT CAREFUL, THE FOLLOWING OPINION EXPRESSED IN THE "OLD FARMER'S ALMANAC" MAY COME BACK TO HAUNT US: "IF PATRICK HENRY THOUGHT TAXATION WITHOUT REPRESENTATION WAS BAD, HE SHOULD SEE HOW BAD IT IS WITH REPRESENTATION."

The CHAIRMAN. Our first witness is Mr. Swain, who is the chief counsel, Office of Advocacy, Small Business Administration.

Frank, I want to take this opportunity to commend you in the handling of that office. You were an unknown quantity to the committee when the administration appointed you. I think you have served your President well, but I think also you've done what the law requires you—to serve the small business community well. It's a great pleasure to have you before the committee.

STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL, OFFICE OF ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Thank you very much, Senator. I appreciate those comments. I'll certainly continue to try to serve the small business community as honestly as I can.

On the specific subject before the committee this morning, tax reform, first of all, I would like to congratulate you and the committee. The committee held an extensive series of field hearings last year on tax reform, and I think the committee report accurately reflects what the small business community is saying to the Congress and that report is also reflected in what we have heard in the various White House conferences on small business.

I will summarize my statement: What the statement tries to do is lay out what we feel are the most important provisions that are up in tax reform for the small business community as a whole. Your later panels this morning include a variety of trade associations and groups that represent in many cases more specific constituencies, so I don't fully expect that they'll totally agree with our statements.

In terms of the general impact of tax reform provisions on the small business community, we think that first and foremost both the President's May 1985 bill and H.R. 3838 contain many items beneficial for small business: The lowering of income taxes for individual will help millions of small proprietors. Graduated corporate income tax rates will serve to maintain progressivity among corporate taxpayers. Changes in depreciation such as simplified the LIFO inventory proposal and allowance of cash accounting are both especially important for small firms. Provisions that generally eliminate a bias in the tax system between and among various industries we think are a step in the right direction.

You certainly recall, Senator, because you were one of the primary sponsors of legislation that did, in fact, implement the No. 1 tax priority of the last White House Conference on Small Business, which is a further graduation and lowering of corporate tax rates. That seems to be, both from the standpoint of opinion and the standpoint of economics, the single most important part of tax reform is that we retain a simplified graduated corporate tax rate. In the current law there is, of course, a four-step graduated tax rate. H.R. 3838 takes that to three steps and slightly liberalizes the tax rates. That's very beneficial for small companies. It's also very beneficial for large companies. That doesn't necessarily stand in the way, but the fact that the graduated tax rates are retained and somewhat broadened we think is the single most important part of the bill.

If there are any other changes in any other parts of the bill, we don't think they should be at the expense of making those graduated rates any higher, because the graduated rates are clearly the part of the tax bill that apply to most small corporations. Clearly, the lower overall individual tax rates will be important to 80 percent of the small businesses, those that are proprietorships. We also have to pay attention to the corporate rates, though, because 65 percent of the small business income is earned by small corporations.

Beyond the graduated rates, I think the first thing that people run into is whether there is a problem with so-called capital formation provisions of either the President's proposal or H.R. 3838, and exactly how to solve that problem.

Again, obviously there are variations between and among industries. What may be a capital formation goal for a manufacturing company may be entirely different or much less relevant for someone in the merchandising area. Nonetheless, the Office of Advocacy has attempted to form some fairly specific economic analysis on the bill, both the President's proposal and H.R. 3838. We have reached some general conclusions related to the impact of the changes in ITC and depreciation.

Our study of the various provisions' impact on small versus large corporate taxpayers indicates that the corporate rate reduction is most beneficial, but a particular important finding was the critical significance of a progressive corporate rate structure to the small corporate taxpayer, for larger corporation rate reductions offset the impact of the ITC repeal, but for many small firms the fact that the corporate rates are about the same, yet the ITC is repealed, may mean that for many small firms their effective tax rate may increase somewhat.

Now how to solve this: Small business may generate capital either internally or externally. There will be a panel later on this morning, I am sure, that will be focusing on capital gains. That's not what we're going to talk about but primarily the internal issue.

The two most common means of internal capital formation available to small business are the ITC, the investment tax credit, and depreciation. Under H.R. 3838 the ITC is slated for total elimination while depreciation would be significantly scaled back.

Our research indicates that for the very smallest firms the changes in ITC are more important, roughly four times more important, than the changes in depreciation. That's because of the impact of the immediate credit or the immediate expensing. For the very largest firms, they're hit much harder on the changes in depreciation.

Therefore, in terms of priorities, it's my personal belief that the broadest sector of the small business community is interested in retaining the graduated rates, but they're also interested in some modest incentives for capital formation.

The President's plan contained a provision to repeal the ITC, but the repeal is balanced by an inflation index depreciation system. The House repealed the ITC, but also took out the inflation index depreciation assistance, so in effect a double whammy for small firms in particular.

From a small business perspective, there might be several solutions to this capital formation problem, but we think something in that direction is necessary to make the bill acceptable to small firms. Among the options that the Senate might consider would be a cap on the overall amount of the investment tax credit available, an increase in the allowing expensing provisions under section 179. The House bill would increase the current $5,000 allowance to $10,000. Maybe some further increases would be possible without sacrificing revenues. Certainly there are various ways to phase in a limited investment tax credit that would be particularly appropriate for small firms.

In other words, there is a variety of options. We certainly don't stand for the proposition that the ITC ought to be put totally back in. It's large revenue loss provision, and most of the revenues lost are by large companies, by the way—87 percent of the ITC's go to the largest companies, companies with over $25 million. So we're not campaigning for the ITC per se, but for some approach that gets something back in the bill for the small firm that doesn't have a large revenue base, that needs a little extra incentive to modernize, to invest in some new equipment.

Overall, we think that the approach of H.R. 3838 is doable. Some modest fine-tuning, especially in the investment tax credit or depreciation area—we do think some limited ITC or expensing expansion would be preferable to depreciation, but we don't think that either one of those should be done at the expense or having it paid for by increasing the tax rates. The tax rates are the most important to most small businesses, and we just don't think you can get away from that.

That is the sum and substance of our statement, Mr. Chairman. We've got a lot more extensive analyses, and we've taken a look at some other sections of the bill, but you've got a lot of other witnesses this morning that will be more articulate on particular provisions.

I'd be happy to answer any questions that you have now or later.

[The prepared statement of Mr. Swain follows:]

PREPARED STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY

Mr. Chairman:

Thank you for the opportunity to discuss reform of the Federal income tax system. As you know the Office of Advocacy of the U. S. Small Business Administration was created by Congress in 1976 to advocate the interests of small business before the Congress and Federal agencies. My views on tax reform are not necessarily those of the Administration; the Department of Treasury represents the Administration on tax issues.

The Committee's interest correctly reflects the importance of this issue to the millions of small business owners across the country. The success of tax reform in eliminating tax induced distortions in our economy and in promoting economic growth will be measured in large part by the way reform treats small business.

I have attended the majority of thirty-three separate meetings of small business owners in various states held pursuant to the White House Conference on Small Business. Over eleven thousand business owners have discussed tax and other issues.

Their sentiments with respect to tax reform are fairly clear. Small business owners favor rate reductions, they favor elimination of divergent tax treatment for different industries. They urgently seek simplification. They are most unanimous in wanting less frequent tinkering with the tax system.

At the same time, small business owners are concerned about the impact of elimination of the investment tax credit, the complications of yet another depreciation scheme. My conversations with hundreds of these small business owners and attendance at dozens of their tax issue discussions permit me to assure you that small business owners will willingly contribute to a simpler, fairer tax system. Small business is most definitely not interested in change for the sake of change.

Successful tax reformers will have considered carefully the impact of their efforts on small business and taken steps to accommodate small business concerns. I say this because new investment, new employment and growth in new industries are small business activities - affected quite directly by the tax burden we place on such activities. A tax system that targets narrow industries or penalizes new investments will so distort small business growth as to deny our economy the strength and benefits that we all recognize are the contributions of small business.

Last December the tax reform effort took a major step forward when the House of Representatives approved H. R. 3838, that bill includes many changes that I believe are important to small business. There are also important small business concerns that I hope will be remedied as the Senate undertakes its own tax-writing efforts. I would like to focus for a few minutes on provisions which affect small businesses.

Overview of Tax Reform & Small Business

Tax reform provisions as presented by the President in his May 1985 proposal and the House in H.R. 3838 contain many items beneficial for our nation and small business. The lowering of income tax rates for individuals will help millions of small proprietors. Graduated corporate income tax rates will serve to maintain progressivity among corporate taxpayers. Similarly the simplified last-in first-out (LIFO) inventory proposal is a step forward for small business. Provisions in both proposals are directed toward eliminating industry bias that has infiltrated the code over decades of change. Small business is likewise very pleased to see the preservation of cash basis tax reporting for small businesses. Truly there are many positive prospects emanating from Treasury II and H.R. 3838 which will benefit small businesses.

However tax reform as currently framed by H.R. 3838 is not perfect, far from it. Small businesses face a plethora of tax changes each time a major tax reform bill becomes law. Change in and of itself has greater negative impact on small businesses as compared to large businesses. Simply stated small business does not have as large a revenue base over which to allocate the cost of interpreting, digesting, and understanding the volumes of tax changes. Therefore if true meaningful reform is to be accomplished it must contain significant results and worth-while changes. These changes must be framed with a sense of equity and fairness in the apportionment of tax increases within the business community. Small firms should not shoulder a disproportionate allocation of business tax increases. Under the House proposal large corporations would receive substantial tax rate reductions. Small corporations would not benefit nearly as much from such rate reductions. Of utmost concern to small business are provisions of H.R. 3838 which would serve to increase the cost of capital, specifically by the repeal of the investment tax credit and depreciation changes. Again, for the very smallest corporations these changes would not be offset by rate reductions.

Perplexing and sometimes seemingly contradictory goals are before us in this critical tax reform deliberation. How do we blend economic and social goals within the tax code? How do these square with the need to maintain Federal revenues? The Office of Advocacy has sponsored a study of certain key provisions of H.R. 3838 in an effort to develop estimates of the relative impact of those provisions. The report is not yet completed but we do anticipate final results in approximately ten days. We do have however, an overview of certain proposed changes impact on the small business community.

Reduction of individual and corporate income tax rates must be a cornerstone of any major tax reform proposal. Approximately 80 percent of our nation's small businesses report the net earnings of their companies as a part of their individual tax returns. Individual rate reductions as set forth in H. R. 3838 and the President's proposals would provide meaningful assistance to a vast number of small proprietors and partnership partners.

Research has shown that approximately 20 percent of small businesses operate as corporations. However, this corporate sector earns 65 percent of the net income earned by all small businesses. Therefore, when examining the potential impact of tax reform on small business, it is very important to consider corporate small businesses. Our study of various H.R. 3838 provisions' impact on small versus large corporate taxpayers indicates that the corporate tax rate reduction is relatively more beneficial for large corporations. A particularly important finding of the study was the critical significance of a progressive corporate rate structure to the small corporate taxpayer. For large corporations, rate reductions offset the impact of ITC repeal, for many small firms this will not be the case.

Capital Formation & Small Business

Small business may generate capital either internally or externally. I will focus my comments on internal capital formation since most small businesses look internally for their capital needs and in that H.R. 3838 directly affects the ability of small firms to internally generate capital. The two most common means of internal capital formation available to small business are the investment tax credit (ITC) and depreciation. Under H.R. 3838 the ITC is slated for total elimination while depreciation would be significantly scaledback. Our research indicates that the ITC repeal will have at least 4 times the impact on small business as the depreciation changes in H.R. 3838.

In terms of priorities, it is my belief that the broadest sector of the small business community is interested in retaining the graduated corporate tax rate system and some capital incentives for business. Both the President's May 1985 proposals and H.R. 3838 would retain a graduated corporate tax system. The President's plan contained a provision to repeal ITC but the repeal was balanced by an inflation indexed depreciation system. However, H.R. 3838 really creates a double whammy for small firms in that it proposes a slower, less generous depreciation system and kills the ITC. Our research indicates that such a combination is especially harmful for the small corporate taxpayer. From a small business perspective a solution to this capital formation problem is necessary in order to achieve acceptable tax reform. Several options and alternatives might be considered. We believe adjustments to the ITC rather than further juggling of the depreciation scheme will yield direct and more accessible benefits for small firms. Clearly the revenue loss potential of restoring the ITC can be significant. Some degree of focusing or capping the ITC would not only stem the revenue loss but provide the modest capital incentives that most small and start-up firms need.

Summary

Small businesses have driven this nation's economy creating new jobs adding to our economic energy through creativity, innovation, and entrepreneurship. H.R. 3838 contains several provisions important to sustaining and promoting a vigorous small business economy. Reduction in individual tax rates will directly benefit a large portion of the small business community. Retention of graduated tax rates for small corporations will minimize tax barriers to growth in a business's early years. Simplified LIFO inventory accounting rules would direct vital assistance toward smaller firms. I applaud such changes. Small business strongly supports the concept of revenue neutrality. However, Mr. Chairman we must not abandon economic incentives crucial to small business for if we do I am uncertain of small business's ability to continue to lead our nation with new jobs and growth. H. R. 3838 provides some preference for small entities -- small bank bad debt loss, small timber companies, cash basis of accounting -- these provisions while negligible in their revenue impact are significant to the operation of small businesses in those industries. I hope that this search for provisions significant to small businesses will continue.

I support tax reform where it truly rewards and encourages the entrepreneurial spirit of our American small business constituency. Thank you. I would be happy to answer any questions at this time.

LOWELL WEICKER, JR., CONNECTICUT, CHAIRMAN

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ROBERT J. DOTCHIN, STAFF DIRECTOR
R. MICHAEL HAYNES, CHIEF COUNSEL
JOHN W. BALL III, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510

February 27, 1986

Honorable Frank Swain
Chief Counsel
Office of Advocacy
Small Business Administration
1441 L Street, N.W.
Washington, D.C. 20416

Dear Frank:

Your testimony at the February 6, 1986 hearing on the impact of tax reform and simplification proposals on small business was extremely helpful to the Members of the Committee. Unfortunately, due to the time constraints of the hearing, several important points raised by your written statement and oral testimony were not fully explored. In order to make the hearing record complete, the Committee would greatly appreciate it if you would provide written responses to the attached questions, which will be included in the printed hearing record.

Your responses should be directed to the Committee on Small Business, United States Senate, Room 428A Russell Senate Office Building, Washington, D.C. 20510, to the attention of Ms. Tracy Crowley, Hearing Clerk.

Again, thank you for your participation at this important Committee hearing, and for promptly furnishing the responses to our questions for the record.

Sincerely,

Dale
DALE BUMPERS
Ranking Minority Member

LOWELL WEICKER, Jr.
Chairman

Enclosure

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

March 17, 1986

Honorable Lowell Weicker, Jr.
Chairman
Committee on Small Business
United States Senate
Washington, D. C. 20510

Honorable Dale Bumpers
Committee on Small Business
United States Senate
Washington, D. C. 20510

Dear Chairman Weicker and Senator Bumpers:

I am enclosing my responses to the specific questions framed by Senator Carl Levin and forwarded in your February 27 letter.

If I can be of further assistance to you or your committee please do not hesitate to call.

Yours very truly,

Frank S Swain
Frank S. Swain
Chief Counsel for Advocacy

Enclosures

Responses to Questions for Frank Swain
Submitted by Senator Carl Levin

1.IS IT CORRECT THAT THE ADMINISTRATION'S POSITION IS TO HAVE A TAX REFORM BILL THAT IS REVENUE NEUTRAL?

Although our office does not officially represent the Administration with regard to tax policy, it is our understanding that the Administration has been seeking revenue neutrality in any tax bill. Secretary of Treasury James Baker has consistently stated that any tax reform proposal must be revenue-neutral in aggregate and that tax reform should not be used as a disguise for a tax increase.

2.WOULD YOU AGREE THEN, THAT TO HAVE A REVENUE NEUTRAL MEASURE WOULD MEAN THAT SOME SMALL BUSINESSES WOULD WIND UP PAYING MORE TAXES THAN THEY DO UNDER CURRENT LAW?

Neutrality does not sort small vs large nor corporate vs non-corporate taxpayers. Neutrality as to tax reform would be "bottom line" neutrality considered in aggregate numbers. My understanding of H.R. 3838 is that the bill is revenue neutral in aggregate, however, approximately $140 billion in tax liability would shift from the non-corporate to the corporate taxpayer. Some of these corporate taxpayers would be small.

3.HOW MANY SMALL BUSINESSES WILL PAY MORE TAXES?

It is not possible to predict with precision how many small businesses would pay more or less tax under H.R. 3838. We do know that approximately 80% of all small businesses report their business income as a part of their individual tax returns. The remaining 20% of our nation's small businesses report their business income as a corporate taxpayer. Our research indicates that proposed tax changes under H.R. 3838 would obviously be of greater benefit to large corporate taxpayers.

When analyzing tax reform changes the type of industry is important in determining which taxpayers pays more or less taxes. For example the impact of repeal of the investment tax credit affects certain industries differently. This difference is exhibited by the attached table excerpted from my letter of February 24, 1986 to Chairman Weicker and the committee.

4. INITIALLY, THROUGH MAKING CHANGES IN THE TAX CODE, WOULD YOU ACKNOWLEDGE THAT REVENUES WOULD BE RAISED?

Changes in the tax code would not necessarily increase total revenues to the Federal government. The proposed changes by H.R. 3838 would not increase net tax revenues. Obviously some of the specific tax reform proposals, such as repeal of the investment tax credit would increase tax revenues while other changes, such as tax rate reductions would decrease revenue.

5. WOULD YOU AGREE THAT ONCE RAISED, THERE ARE TWO OPTIONS THAT ONE HAS WITH RESPECT TO USING THESE REVENUES--YOU COULD EITHER REDUCE THE DEFICIT OR MAKE OTHER CHANGES IN THE TAX CODE WHICH WOULD HAVE THE EFFECT OF CUTTING TAXES?

It is not clear that the major tax proposals currently under consideration will raise net revenue, in fact they are expressly revenue neutral. There are of course two ways to treat revenues raised by specific changes. One is to offset the revenue increase with tax reductions, the other is to allow the increases to go without offset, resulting in a tax increase. Small businesses that I hear from would join me in opposing this second course.

6. HAS THE SBA CONDUCTED ANY SURVEYS ASKING SMALL BUSINESSES HOW THEY WOULD LIKE TO SEE THE REVENUES USED--FOR DEFICIT REDUCTION OR TAX CUTS?

The U.S. Small Business Administration has not conducted any specific surveys asking small business owners how they would like to see revenues used-- for deficit reduction or tax cuts. Informal discussions with small business owners have provided antedoctal comments on this question. Small business owners think the deficit reduction is extremely important while at the same time they feel that the deficit should be approached with focused attention on the spending side of the ledger before considering any increase in taxes. In the last two annual small business capital formation conferences sponsored by the Securities and Exchange Commission, participants voted to first reduce the deficit.

7.I WOULD ASK THAT YOU DO CONDUCT SUCH A SURVEY IF YOU HAVE NOT ALREADY, AND REPORT THE RESULTS OF THE SURVEY TO THE SMALL BUSINESS COMMITTEE.

As I have stated above we have not initiated a formal survey of the small business owners. However, small business owners across the country are currently meeting at White House Conferences on Small Business in every state to make recommendations on issues such as this. The small business owners attending these state meetings have indicated that deficit reduction through spending cuts is one of the top small business priorities. There is no suggestion in these meetings that the deficit be reduced through tax increases.

IMPACT OF SELECTED PROVISIONS OF H.R. 3838 BY FIRM AND INDUSTRY DESIGNATION

This information is excerpted from a study performed for the Office of Advocacy by Price Waterhouse & Co. The study is intended to ascertain the impact of certain tax changes. Impact of tax changes is measured not only in terms of absolute percentage point changes but also in terms of relative change by firm size.

The "marginal effective income tax rate" concept used in the following tables measures the difference between the after tax rate of return from a $100 business investment and the rate of return before taxes. The rate of return is calculated as the annual return (annualized net revenues achieved from a $100 business investment over a 30 year period) as a percent of the total amount invested. The differences between the before tax rate of return and the after tax rate of return will provide the percent by which the tax system reduces or increases the rate of return on such business investment.

Therefore, the effective tax rate is the difference between the before tax rate of return and the after tax rate of return as a percent of the before tax rate of return. It must be understood that the rate of return is based on an annualized stream on income generated (i.e., annualized revenues net of cost and taxes generated by that $100 investment) as a percent of the investment made for that period.

Table 1 Change in Marginal Effective Income Tax Rates Attributable to Repeal of the Investment Tax Credit

	Asset Size			
Industry Sector	$1 to $500,000	$500,000 to $5 million	$5 million to $25 million	Over 25 million
Manufacturing	8.9	7.0	6.5	5.9
Service	9.5	14.3	13.7	10.3
Merchandising	5.7	4.7	4.3	4.9

The CHAIRMAN. Thank you very much, Frank.

I would suspect that what will happen is that as we firm up a Senate bill I will be consulting with you as to what the impact is on small business, so I really have no further questions at this time.

Your testimony in its entirety will be included in the record. As I say, you can expect that we will be consulting a little bit later in the year.

Senator Sasser.

Senator SASSER. I have no questions at this time, Mr. Chairman. I do have an opening statement which I would like to have incorporated in the record as if read.

The CHAIRMAN. The statement will be included in its entirety in the record at this point and also a statement by Senator Alan Dixon will be included in the record at this point.

[The prepared statements of Senators Dixon and Sasser follow:]

ALAN J. DIXON
ILLINOIS

United States Senate
WASHINGTON, D.C. 20510

Statement By Senator Alan J. Dixon

Senate Committee on Small Business

The Impact of Tax Reform and Simplification on Small Business

Feb. 6, 1986

Mr. Chairman, the objectives of tax reform are sound. Everyone wants a tax code that is simple, fair and equitable. There is no question that the tax code is drowning in complexity.

There is also no question that the tax code is unfair. According to a survey made by the Internal Revenue Service, more than 80 per cent of taxpayers believe the tax code is unfair and mainly benefits the rich. A majority believe that more than 25 per cent of taxpayers cheat, and 20 per cent themselves admit to cheating.

We all want a fairer and simpler tax code, but there are other objectives a tax reform proposal must also achieve. We also want to ensure that our tax laws promote economic growth and the incentives for savings and investment that create

ALAN J. DIXON
ILLINOIS

United States Senate
WASHINGTON, D.C. 20510

economic growth. This is particularly important for small business, which generates most of the jobs in this country. It is vitally important to insure that any tax reform proposal does not reduce the ability of small business to create the jobs we so badly need.

Thirteen field hearings were conducted in 1985 to discuss the impact of tax reform and tax simplification on small business. Retention of the Investment Tax Credit was one of the major issues focused on by the witnesses in each of these hearings. The ITC is part of the larger "capital formation" issue for small business. Capital, whether it be through borrowed debt or equity investment, is frequently difficult for small business to obtain. Therefore, small firms must generally rely on earnings to generate the required capital growth. The ITC is a mechanism which enhances cash flow by reducing tax liability, and has therefore become a particularly important source of capital to small business. Any tax reform proposal effort must keep this in mind.

Another issue being discussed is the taxing of employee benefits. I have long believed that the special tax treatment afforded employee benefits has been essential in implementing critical social goals and has created excellent health care and pension plans. Even though small businesses are the principal job creating sector of the economy during recessions and expansions, small businesses are likely to offer fewer and less comprehensive fringe benefits than large businesses.

Making fringe benefits available in small firms is critical in hiring and retaining productive workers and competing with large firms. It is important, therefore, that the impact of taxing employee benefits must be carefully reviewed during our considerstion of tax reform.

Mr. Chairman, I am keenly interested in tax reform legislation that is sensitive of the needs of one of the most important elements of our economy--the small business. I appreciate the opportunity to participate in this hearing, and look forward to the statements of the witnesses gathe ed here today.

STATEMENT OF SENATOR JAMES R. SASSER

MR. SASSER: MR. CHAIRMAN, TODAY'S HEARINGS REFLECT THIS COMMITTEE'S CONTINUING INTEREST IN GUARANTEEING THAT THE CONCERNS OF SMALL BUSINESS ARE ADDRESSED IN ANY TAX REFORM BILL TAKEN UP IN THE SENATE. THE SMALL BUSINESS COMMITTEE CONDUCTED 13 FIELD HEARINGS IN SEVEN STATES ON THE ISSUE OF TAX REFORM AS IT RELATES TO SMALL BUSINESS. I WAS PROUD TO CHAIR THE FIRST OF THESE FIELD HEARINGS IN MY HOME STATE OF TENNESSEE IN JANUARY OF 1985. I AM EQUALLY PROUD TO TAKE PART IN THE CONTINUATION OF THIS EFFORT TODAY.

THE KEEN INTEREST OF THE MEMBERS OF THIS COMMITTEE IN TAX REFORM REFLECTS WHAT TAX REFORM SHOULD BE ABOUT. WE CAN AND SHOULD BE USING THE PRESENT TAX REFORM DEBATE TO CONSTRUCT A TAX POLICY WHICH PROMOTES ECONOMIC GROWTH AND SIMPLIFIES THE TAX CODE FOR SMALL BUSINESS. SMALL BUSINESS IS THE VIBRANT, GROWING

SEGMENT OF OUR ECONOMY. WE NEED A NATIONAL TAX POLICY WHICH STIMULATES ENTREPRENEURIAL ACTIVITY AMONG THESE FIRMS.

A FEW FACTS UNDERSCORE THE IMPORTANT ROLE OF SMALL BUSINESS IN OUR ECONOMY. AS NOTED IN THE PRESIDENT'S REPORT ON THE STATE OF SMALL BUSINESS, SMALL BUSINESS LED THE NATION IN JOB CREATION IN 1984. EMPLOYMENT IN SMALL BUSINESS DONMINATED INDUSTRIES EXPANDED BY 11.4% FROM OCTOBER 1982 - OCTOBER, 1984, WHILE EMPLOYMENT IN INDUSTRIES DOMINATED BY BIG BUSINESS GREW BY ONLY 5.3% FOR THIS SAME PERIOD. PERHAPS THE BEST EVIDENCE OF SMALL BUSINESS' JOB GENERATING CAPACITY WAS SEEN FROM 1980-1982, WHEN SMALL BUSINESS ACCOUNTED FOR ALL THE NET NEW JOBS IN THE UNITED STATES.

MANY OF THESE ENTREPRENEURS WHO ARE AT THE CUTTING EDGE OF INNOVATION WERE NOT SATISFIED WITH THE PROVISIONS OF THE

ADMINISTRATION'S TAX REFORM PROPOSALS. THE NATIONAL ASSOCIATION OF ACCOUNTANTS SURVEYED ITS MEMBERS ON THE ADMINISTRATION'S REFORM PROPOSAL LAST SUMMER. THIS ASSOCIATION OF MANAGEMENT ACCOUNTANTS WHO HAVE FIRST-HAND KNOWLEDGE OF SMALL BUSINESS PROBLEMS FOUND ITS MEMBERS BELIEVED THE ADMINISTRATION'S PROPOSAL WOULD HURT SMALL BUSINESS AND ECONOMIC GROWTH.

IT WAS EXACTLY SUCH FEARS WHICH LED MYSELF AND MY COLLEAGUES TO INTRODUCE SMALL BUSINESS TAX REFORM BILLS LAST YEAR. MANY OF THE ISSUES RAISED IN OUR LEGISLATION HAVE BEEN AT THE CENTER OF THE DEBATE ON SMALL BUSINESS TAX REFORM CONCERNS. IT IS OUR INTENTION TO KEEP THESE ISSUES AT THE FOREFRONT OF THIS DEBATE AS ITS FOCUS SHIFTS TO THE SEANTE.

MAINTAINING PROGRESSIVE CORPORATE RATES FOR ALL SMALL BUSINESSES AND ESTABLISHING A STRONG DIRECT EXPENSING PROVISION

WILL ADDRESS THE CAPITAL FORMATION NEEDS OF MANY SMALL FIRMS. THIS WILL HELP CONTINUE THE STRONG GROWTH RECORD OF SMALL BUSINESS. APPLYING THE REGULATORY FLEXIBILITY ACT TO THE INTERNAL REVENUE SERVICE AND ALLOWING SMALL FIRMS TO UTILIZE CASH ACCOUNTING IN CERTAIN CASES GUARANTEE A GREATER DEGREE OF TAX SIMPLIFICATION FOR SMALL FIRMS. I KNOW MY COLLEAGUES HAVE PROPOSALS OF THEIR OWN WHICH ALSO PROMOTE THESE IMPORTANT OBJECTIVES.

WE WILL BE WORKING CLOSELY TOGETHER TO RAISE THESE POINTS IN THE DAYS AHEAD. FOR IT IS MY BELIEF, AND ONE THAT I KNOW IS SHARED BY MANY OF MY COLLEAGUES, THAT WE CAN HAVE MEANINGFUL TAX REFORM WHICH FOSTERS ECONOMIC GROWTH AND SIMPLIFICATION FOR SMALL BUSINESS.

Mr. **Swain**. I might add just one thing, Senator. I suppose it goes without saying that we deal with the committee all the time, but I should articulate that I appear as the counsel for advocacy and didn't necessarily receive any Treasury clearance, and it's certainly not to be implied as the official policy of the Treasury Department at this point.

The **Chairman**. I understand that. Thank you very much, Frank.

Now our first panel of witnesses consists of Mr. Frank Fairbanks of SBU, Mr. Abraham Schneier of NFIB, and Mr. Roger Vail of the National Retail Merchants Association.

All right, gentlemen, why don't we go in order. Senator Bumpers has just joined us and, if he has an opening statement, we will be more than delighted to receive it.

Senator **Bumpers**. With your permission, Mr. Chairman, I will submit an opening statement for the record.

[The prepared statement of Senator Bumpers follows:]

OPENING STATEMENT: SENATOR DALE BUMPERS

I AM SURE MANY OF THE WITNESSES HERE TODAY NEVER THOUGHT THAT THE DAY WOULD COME WHEN THE SENATE WOULD BE REVIEWING THE HOUSE TAX REFORM BILL. AND, I AM SURE THERE ARE MANY MORE WHO STILL HOPE THAT THE SENATE WILL CHOOSE NOT TO TAKE UP THE ISSUE, BUT WILL DEAL INSTEAD WITH THE DEFICIT FIRST AND THEN NEVER GET AROUND TO TAX REFORM.

I CAN TELL YOU HONESTLY THAT I NEVER THOUGHT THE HOUSE WOULD APPROVE A TAX REFORM BILL AND THAT I NOW FEAR THAT TAX REFORM WILL, IN FACT, DISTRACT THE SENATE FROM A MUCH MORE IMPORTANT ISSUE -- DEFICIT REDUCTION. I WILL BE INTERESTED TODAY TO SEE WHETHER YOUR TESTIMONY WILL REINFORCE THESE VIEWS AS YOU PRESENT TO THE COMMITTEE YOUR ANALYSIS OF THE PRESIDENT'S PROPOSAL AND THE HOUSE BILL.

I CAN TELL YOU THAT IF WE ARE TO HAVE TAX REFORM, I WILL NOT SUPPORT IT UNLESS IT IS HELPFUL TO SMALL BUSINESSES. ANY TAX REFORM BILL THAT IS NOT HELPFUL TO SMALL BUSINESSES DOES NOT CONSTITUTE REFORM. THE PURPOSE OF THESE HEARINGS IS TO FOCUS THE COMMITTEE ON A SMALL BUSINESS TAX REFORM AGENDA SO THAT, IF THERE IS A TAX REFORM BILL, THE INTERESTS OF SMALL BUSINESS WILL BE FULLY TAKEN INTO ACCOUNT.

THE MORE I STUDY THE ISSUE OF TAX REFORM THE CLEARER IT IS TO ME THAT MOSTLY TAX REFORM JUST SHUFFLES AROUND BILLIONS OF DOLLARS IN TAX BREAKS FROM ONE BUSINESS TO ANOTHER, FROM ONE REGION OF THE COUNTRY TO ANOTHER, FROM ONE INDUSTRY TO ANOTHER, AND FROM INDIVIDUAL TAXPAYERS TO CORPORATE TAXPAYERS.

THAT KIND OF SHUFFLING HAS ONE CERTAIN EFFECT, CONFUSION, PARTICULARLY FOR SMALL BUSINESSES. THEY SIMPLY CANNOT ADJUST TO A FIFTH MAJOR TAX BILL IN EIGHT YEARS. FOR SMALL BUSINESSES, WHATEVER ADVANTAGES THERE MIGHT BE IN CHANGING THE TAX BILL ARE OFTEN OFFSET BY THE BURDEN OF ADJUSTING TO THE CHANGES.

I SUPPORT GIVING TAX RELIEF TO MIDDLE AND LOWER INCOME TAXPAYERS AND TO SMALL BUSINESSES IF WE CAN DO IT WITHOUT AGGRAVATING THE BUDGET DEFICIT.

I SUPPORT ENSURING THAT ALL TAXPAYERS PAY AT LEAST SOME FEDERAL INCOME TAX.

I SUPPORT CRACKING DOWN ON THE TAX LOOPHOLES WHICH MAKE THE CURRENT INCOME TAX SO COMPLEX AND UNFAIR.

BUT, REDUCTION OF THE BUDGET DEFICIT SHOULD BE OUT FIRST, SECOND, THIRD, FOURTH, FIFTH AND SIXTH HIGHEST PRIORITY. IF WE DO NOT GAIN CONTROL OF THESE DEFICITS, ALL TAXPAYERS WILL HAVE A LOT LESS INCOME ON WHICH TO PAY TAXES AND THE GOVERNMENT BUDGET DEFICITS WILL EXPLODE. IN MY VIEW, THE ECONOMCY IS LIVING ON BORROWED TIME AND THE BILLS FOR THE PAST FIVE YEARS OF EXTRAVAGANT CONSUMPTION ARE SHORTLY GOING TO COME DUE. REFORMING THE TAX CODE -- WORTHY AS IT MAY BE -- PALES IN IMPORTANCE TO THE NEED TO FULLY IMPLEMENT THE GRAMM-RUDMAN LEGISLATION AND MEET THE DEFICIT REDUCTION GOAL.

The **Chairman**. At this time we'll proceed with testimony. Why don't we proceed in the order as stated? Mr. Fairbanks, why don't you proceed?

STATEMENT OF FRANK B. FAIRBANKS, PRESIDENT, HORIX MANUFACTURING CO., McKEES ROCKS, PA; REPRESENTING SMALL BUSINESS UNITED

Mr. **Fairbanks**. Mr. Chairman, I'm Frank Fairbanks. I'm here today representing Small Business United. I am representing also the Smaller Manufacturers Council of Pittsburgh. I am past chairman of the Smaller Manufacturers Council, and I am currently president of Horix Manufacturing Co., a manufacturer of packaging machinery in the Pittsburgh area.

I will briefly summarize my written statement for the record.

Small Business United supports the following aspects of H.R. 3838: Retention of preferential capital gains treatment; retention of appropriate graduation; lower individual and corporate maximum tax rates; continuation of the present deductibility of health insurance benefits; and revenue neutrality.

However, we vigorously oppose the elimination of ITC and ACRS. We feel that this will add a further bias against investment and savings. We urge retention of the ITC, with a cap if necessary, and ACRS.

H.R. 3838's 80-percent limitation on the deductibility of reimbursed business and travel entertainment expenses is an unwarranted intrusion of the Federal Government in the determination of what are ordinary and necessary expenditures in the conduct of business. The additional corporate tax has no real relationship to the alleged preferential treatment of the person whose expenses are reimbursed. The effect, as far as the corporation is concerned, is a 7.2-percent excise tax on such meal expenses.

We suggest that the retirement and profit-sharing rules have been extensively and sufficiently reformed in three recent tax laws. We advocate no change in this area at all. We suggest the possible compromise of a simple $12,000 annual limit on 401(k) contributions with no IRA offset.

Mr. Chairman, the goals of tax fairness and tax simplification are supported by all of us, but what is viewed by some as fair in the sense of tax equity may not be fair in the sense that it will stifle economic growth, reduce our Nation's international commerce, and reduce or perhaps eliminate job opportunities. Tax fairness will mean nothing if a bill is signed into law which retards savings and investment and stifles the economy. We'll all be worse off even if we do have a fairer Tax Code.

I would be pleased to answer any questions.

[The prepared statement of Mr. Fairbanks follows:]

PREPARED STATEMENT OF FRANK B. FAIRBANKS, REPRESENTING SMALL BUSINESS UNITED SMALLER MANUFACTURERS COUNCIL

I am Frank Fairbanks, a past chairman of the Smaller Manufacturers Council (SMC), and President of Horix Manufacturing Company.

I am testifying on behalf of Small Business United (SBU), a national organization whose members are local, state and regional small business groups from throughout America. SBU's member organizations represent more than 35,000 small business owners from every facet of American industry.

SMC is a voluntary business association of over 2,200 firms, over 1,100 of whom are manufacturers. Our members are primarily located in western Pennsylvania, but we believe that the concerns expressed in this testimony today are fully representative of small manufacturing throughout this country.

Horix Manufacturing Company, with headquarters and manufacturing facilities located in the metropolitan Pittsburgh area, is a manufacturer of packaging machinery, specifically machinery for filling noncarbonated liquids into plastic, glass and metal containers.

Within the context of tax reform, we are particularly concerned about the "full service" small manufacturer, such as Horix, which has a proprietary product, and which must perform complete marketing, product development, custom engineering and manufacturing functions. If such firms are adversely affected in a significant degree by changes in the tax code, many small service firms and "job shop" manufacturers will suffer a loss of business activity as well.

In my testimony today, I would like to speak briefly on some of the tax issues of significance to this important sector of our economy.

Fairness

We commend the efforts of the President and the House to undertake a major revision to improve the equity and perceived fairness of the Internal Revenue Code. The present high marginal rates for individuals and corporations encourage both legal tax avoidance and illegal tax evasion, eroding public confidence in the entire tax system.

Like many taxpayers, SBU's members have no objection to most of the "incentives" in the current Code. On a case-by-case review, they usually have valid social and/or economic objectives. But we also recognize that the usage of such incentives, by individuals or corporations, to reduce the rate of tax on reported income to a low or even zero level permits some taxpayers to avoid paying what the general public might consider a fair share of the cost of government. The fact that predominantly only wealthy individuals and corporations are able to employ such incentives is a further source of concern to the average taxpayer. We recognize the political appeal of limiting deductions and tax preferences so that all individuals and corporations with substantial economic income pay some reasonable share of the costs of government.

It is apparent that the Internal Revenue Code is a balancing act among the incentives deemed necessary to achieve economic and social goals. Regrettably, we believe H.R. 3838 errs too much against incentives necessary to promote economic growth, investment in productive machinery and equipment, and errs too much against incentives to save.

H.R. 3838 compounds the thrust of Treasury II by further increasing the tax burden on corporations, and in particular on capital-intensive enterprises, a category which includes many small manufacturers. Small manufacturers may not be as capital intensive as large ones, but the per-capita investment contrast is reduced if one excludes those industries which require great economies of scale and high investment in production facilities, such as petroleum refining or steelmaking.

Corporate Taxes

H.R. 3838 quite properly provides for graduated corporate taxes. However, it does not reduce marginal tax rates for companies with less than $25,000 of taxable income, and thus is not consistent with the concept of basic rate reduction for most taxpayers, especially those at lower income levels. While larger firms losing such incentives as the Investment Tax Credit would make up some of their losses through reduced marginal tax rates, the same is not true for the truly small capital intensive business.

Investment in Machinery and Equipment

Most small manufacturers are not high-growth companies. We often serve relatively mature markets, and to the extent we are able to do so in today's highly competitive world economy, many of us also sell in foreign countries as well. We desire to retain, if not expand, our domestic production base.

The key ingredient in revitalizing this country's productive capacity is not investment in buildings and inventory, but in productive machinery. Most small enterprises such as ours do not have the growth rate potential to attract venture capital. We must rely on internal earnings and cash flow which would be dramatically reduced by H.R. 3838 through the elimination of the Investment Tax Credit and modification of the Accelerated Cost Recovery System. The reduced investment benefits created by H.R. 3838 would have a crippling affect on my business.

Today Horix is struggling to survive in a world economy in which many nations subsidize their industries with both domestic production incentives (such as interest free loans) and export incentives. The American packaging machinery industry is currently experiencing an excess of imports over exports. Prior to 1984, for at least three decades, our industry's exports significantly contributed to a favorable balance of payments. The role reversal has been rapid, as the chart included in my written report vividly illustrates. We don't need Congress and the Administration to further help foreign manufacturers by eliminating the ITC, the principal mechanism in the tax law which reduces the bias of income taxation against investment versus consumption. SBU supports the continued use of the ITC, albeit with a cap to reduce revenue loss. Within the constraints of revenue neutrality, we urge the Senate to reverse the anti-investment trend in H.R. 3838.

Tax law changes that would make American manufacturers less eager to modernize will only lead to the further demise of production capacity. Studies in the Philadelphia area, for example, indicate that the majority of small businesses are not modernizing their facilities with state-of-the-art equipment such as CNC (computer numeric control) machine tools or CAD-CAM (computer-assisted drafting/computer-assisted manufacturing) systems. On the average, the addition of 100 manufacturing jobs in a community adds 64 non-manufacturing jobs, in such fields as construction, service, banking and education. We must not let the push for tax fairness adversely impact the modernization of basic manufacturing facilities, both large and small, that are a very essential part of this nation's strength.

Fringe Benefits

We are pleased that the House of Representatives did not impose any tax on employer-provided health benefits. We believe that employer benefits of this nature are a reasonable and appropriate expense of doing business, and it thus is a matter into which government should not intrude. We suggest that, from a standpoint of fairness, self-employed individuals should likewise be permitted a business deduction for health insurance costs.

With respect to pension and profit-sharing plans, constant legislative tinkering has imposed excessive compliance costs, particularly on small firms, in keeping up with the significant alteration of rules under the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1984, and the Retirement Equity Act of 1984. Increasing the plan complexity and the almost impossible ability to prepare currently accurate "summary plan descriptions" have eroded the confidence of the average employee as to any certainty of what he or she might receive at retirement. The Internal Revenue Service might better use its personnel for audits than in continually reviewing retirement plan revisions which typically have a minor impact.

We suggest that the tax code as it pertains to pension, profit sharing, and salary deferral plans has already been adequately "reformed." SBU does not support H.R. 3838 restrictions on Section 401(K) plans. At a minimum, the Senate should adopt an alternative proposal considered by the House to limit a 401(K) contribution to $12,000 annually with no IRS offset. Preferably, the Senate will retain current law.

Entertainment Deductions

We see the 80% limitation on the deductibility of business meals as a burdensome accounting requirement and an inappropriate intrusion by the federal government in the determination of the appropriateness of costs which are incurred in the conduct of business. It appears that the effective impact of the 80% limitation is the equivalent of a non-deductible 7.2% excise tax on business meal reimbursements.

For example, it is currently difficult to employ service engineeers who are willing to travel away from home for the greater part of every week. Therefore, under H.R. 3838 we will continue to reimbruse them for their entire travel and living expenses, including full reimbursement for meals. Meal expenses will, of course, have to be separately classified for accounting purposes because of the different deductibility. We will just recognize that for each $10 of reimbursed meal expenses, our company will incur (at the proposed 36% corporate marginal rate) an additional 72 cents in taxes.

Summary

We support the following aspects of H.R. 3838: (a) retention of preferential capital gains treatment; (b) retention of corporate graduation; (c) lower individual and corporate maximum tax rates; (d) continuation of the present deductibility of health insurance benefits; and (d) revenue neutrality.

We vigorously oppose the elimination of ITC and ACRS, as we feel that this adds a further bias against investment and savings in a nation whose savings rate is already extremely low. We urge retention of the ITC, with a cap if necessary, and ACRS.

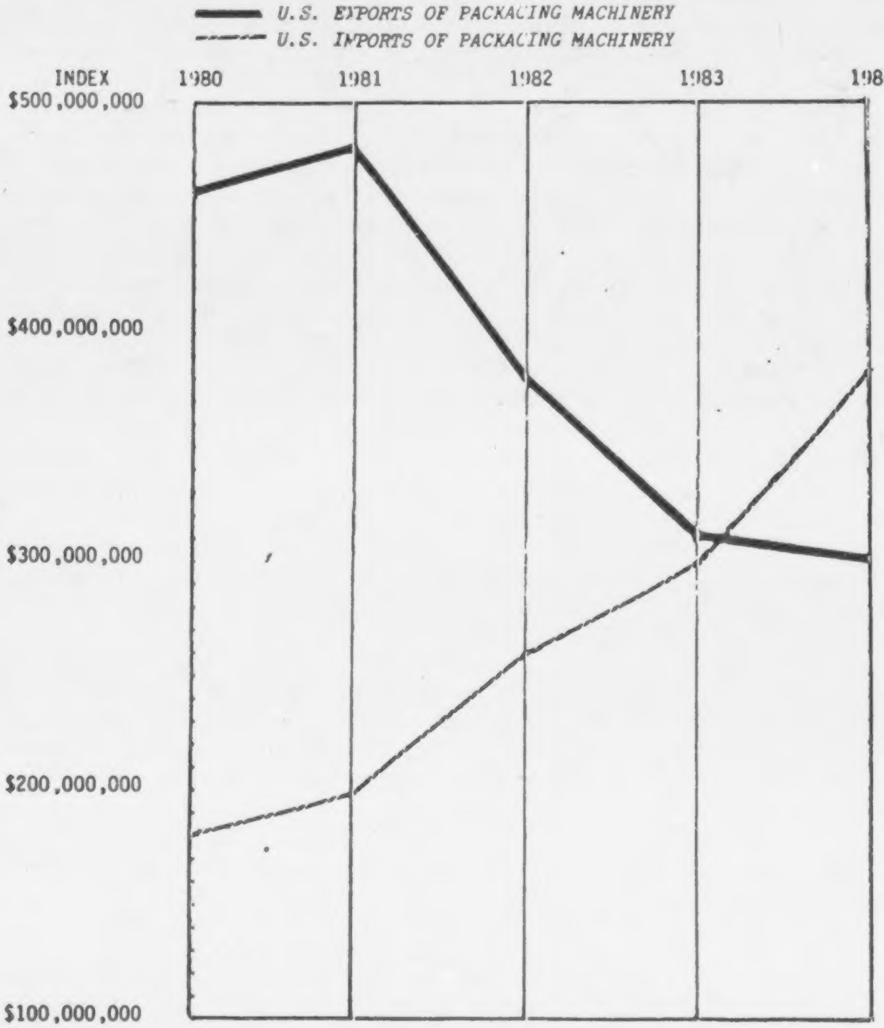
H.R. 3838's 80% limitation on the deductibility of reimbursed business travel and entertainment meals is an unwarranted intrusion of the federal government in the determination of what are ordinary and necessary expenditures in the conduct of business. The additional corporate tax has no real relationship to the alleged preferential treatment of the person whose expenses are reimbursed.

We suggest that the pension and profit-sharing rules have been extensively and sufficiently reformed in the past three tax laws. We advocate no change, but suggest the possible compromise of a simple $12,000 annual limit on 401(K) plans with no IRA offset.

Mr. Chairman, the goals of tax fairness and tax simplication are supported by all of us. But what is viewed by some as fair in the sense of tax equity may not be fair in the sense that it will stifle economic growth, reduce our nation's industrial competitive edge in international commerce, and reduce or perhaps eliminate job opportunities. Tax fairness will mean nothing if a bill is signed into law which retards savings and investment and stifles the economy. We'll all be worse off albeit with a "fairer" tax code.

Attachment 1

U.S. EXPORTS-IMPORTS OF PACKAGING MACHINERY 1980-1984



The **Chairman**. We will leave questions until all of the members of the panel have had a chance to testify.

Mr. Schneier.

STATEMENT OF ABRAHAM SCHNEIER, TAX COUNSEL, THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. **Schneier**. Thank you, Mr. Chairman.

Good morning. My name is Abraham Schneier, and I am here representing the National Federation of Independent Business.

I would first like to begin by echoing some of the sentiments expressed by Mr. Swain earlier about the importance of individual rates and the importance of that to the broad small business community. In fact, this morning, in reviewing the recommendations of the 1980 White House conference, the No. 1 goal stated was to equalize tax burdens on small businesses relative to large corporations in order to increase new business starts and to provide existing small companies with more retained earnings for investment. We feel that these goals are in large part not being totally reached, but certainly are being approached by the tax reform proposal by the President of last May and also by the proposal of H.R. 3838.

In our surveys of the membership over the years the No. 1 issue continuously brought up is rates, rates, and rates. In fact, just as recently as late 1984 a survey of the NFIB membership revealed that about 74 percent would prefer to see individual rates the major area addressed in any tax reform proposal.

The prime reasons for that are probably quite obvious. The basic makeup of the small business community, a large part of the small business community, approximately 70 percent according to the data from the small business data base, include retail, wholesale, and service sector businesses. For these businesses, the importance of the rate reduction certainly outweighs the relative benefits of the investment tax credit and ACRS. In fact, these industries, retail or wholesale, are among the highest effective rate taxpayers currently in our economy, as stated by studies by the Joint Committee on Taxation on effective tax rates.

The support for H.R. 3838 on behalf of NFIB is also keyed on the fact that we believe that it is good for the general economy. Certainly there are many capital-intensive small businesses. However, among the largest capital-intensive businesses in the country, they feel that the provisions of eliminating the investment tax credits and curtailing of depreciation benefits will not impact dramatically on the economy. Among those corporations are General Motors, IBM, and many of the Fortune 100's.

There have been several reviews recently in the Senate Finance Committee of the impact of the tax reform proposal on the general economy. I think, as we have read in the papers, there is quite a divergence of opinion among economists. Clearly, there is no clear understanding of the fact that a program like H.R. 3838 or the President's proposal would have a detrimental effect on the economy. In fact, we believe the opposite—that it would be positive for small business and entrepreneurship specifically.

Among issues which NFIB is additionally supportive of besides rates and specifically which were dealt with in H.R. 3838 include the inventory accounting proposal which will simplify the LIFO provisions and the proposal for increasing the expensing. We would agree that there is a concern for some small corporations who are not receiving any rate reductions under the new graduated proposal in H.R. 3838, and by loss of the investment tax credit, which is very important to low rate taxpayers, that they could have tax rate increases. We would certainly like to see something in that area addressed either through addressing the rate issue or addressing the expensing provisions.

We would also like to see several other issues addressed for small business. One of them specifically would deal with the rate with which a small business must pay payroll taxes to the Government. Currently, if your withholdings for Social Security and Federal withholding taxes exceed $3,000, you could be placed into a situation where you may have to pay taxes eight times a month to the Federal Government. This is not a tax increase or tax reduction proposal; it merely deals with the timing of making deposits to the Federal Government. We feel once a month should be more than sufficient for small businesses. The paperwork inherent in that kind of a situation is incredible.

Also, we are concerned that there is not sufficient parity right now on health insurance deductions between corporate forms of businesses and noncorporate businesses. We would also like to see the IRS be brought into the reality of having to deal with the Regulatory Flexibility Act, and we would like to see the issue of the attorneys' fees proposal under the Equal Access to Justice Act addressed. We believe that these additional regulatory and paperwork proposals would certainly add to the simplification goals of tax reform.

I would like to thank you for the opportunity, and I am available for any questions you may have.

[The prepared statement of Mr. Schneier follows:]

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The Guardian of Small Business

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STATEMENT OF
ABRAHAM SCHNEIER

ISSUE COORDINATOR--TAX, TRADE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Small Business Committee

Subject: Tax Reform

Date: February 6, 1986

My name is Abraham Schneier, and I am the tax issue coordinator for the National Federation of Independent Business. On behalf of the more than 500,000 members of the NFIB, I am happy to be appearing before you today to discuss the issue of tax reform and the impact tax reform will have on the small business community.

There are few issues which so ignite the anger of a small business owner as the subject of taxes. Is there another area of government control which places so great a burden on the small business owner as the need to comply with tax regulations and to pay taxes? Clearly, there is not. Time after time small business owners state that reform of our system of taxation to make a simpler, and, more equitable system should be a priority of government--in fact, with the exception of reducing the budget deficit, tax reform should be your highest priority.

A little more than a year ago the debate over tax reform began in earnest with the release of Treasury I and the subsequent release of the President's proposal for tax reform. As a starting point, both documents provided a specific outline for revenue-neutral tax reform, espousing the goals of economic growth, fairness, and simplicity. After the introduction of these proposals, both the House and the Senate tax writing committees held several months

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of hearings on each of the critical issues presented in those documents. Finally, at the end of last year, the House Ways and Means Committee completed a tax reform proposal, and it was passed by the House of Representatives.

How well the goals of tax reform are achieved and how the House tax reform proposal will impact on small business are the subjects at hand today. To state our position up front, it is the majority opinion of the NFIB membership that the House tax reform proposal is a positive step forward to a more favorable tax system for small business. The House proposal achieves this goal by providing substantial tax rate reductions, an important issue to the broad spectrum of small business owners. The majority of NFIB members feel that, while some aspects of the House-passed bill are cause for concern, many of the small business objectives for tax reform are achieved, either in part or in whole. Most importantly, it is also their opinion that the process of tax reform should continue to move forward.

Macroeconomic Concerns

Just last week the Senate Finance Committee began a series of hearings designed to determine what the economic effect of the House tax reform proposal will be on the economy in general. It appeared to be the general consensus of those appearing before the Committee that the House bill would result in a reduction of up to 3% in business investment by 1990.

It was predicted by one economist that the after-tax cost of capital will increase by up to 15%. In terms of foreign trade, the overall cost of U.S. goods would increase by 2 percent. All of the panelists concluded that Congress should reinstate the investment tax credit and reduce the tax benefits being received by individuals.

As representatives of small businesses, we must be concerned with this misperception of policymakers that the single most pressing issues for the business community at large are the retention of the investment tax credit and the cost of capital.

In 1981, 94% of the benefits of the investment tax credit were directed towards corporations with assets of $1 million dollars or more. Of even greater importance, even though the investment tax credit has been available to large firms, over the last five years the growth in productivity has been far below previous recoveries.

In contrast, over the period of 1976 through 1982, small firms with less than twenty employees generated sufficient economic growth to increase their level of employment by over 220 percent. Clearly, for many small firms the cost of capital involved other considerations beyond recovering the cost of an investment via the tax benefits available through depreciation and the investment tax credit. The impact reduced tax rates have on individual incentives to invest, to risk, and to work harder are not measurable in the context of the econometric models of the major economic bases. This is best illustrated by the fact that none of the major econometric models came close to predicting the strength or length of our current economic recovery.

While analysts differ widely on the potential economic impact of changes in the tax law as broad as the President and the House have proposed, there is unanimity on the point that their effects cannot be predicted with certitude. Conclusions must be drawn on the preponderance of evidence available, with common sense judgments about the economic behavior of investors and businesses being the most important tool in evaluating tax reform. This point is illustrated by the fact that several capital intensive corporations have reviewed the tax bill and found that based on their plans and predictions, the House passed tax bill will result in greater economic growth, not less.

According to the Small Business Administration Small Business Data Base, their are 4,723,716 business establishments in America. 71 percent of these firms are retailers, wholesalers, and service firms. For these firms, and for their owners and employees, reductions in tax rates and changes in inventory accounting procedures will promote far more economic growth than the investment tax credit. Even for capital intensive firms, the benefit of expanded savings, new business formations, and increased sales should more than overcome the loss of the investment tax credit.

The debate over ITC and ACRS centers on the need for tax policy to direct capital to particular uses, such as investment and the consumption of capital goods. There is little or no evidence that ITC and ACRS have brought America's failing industries back to health; steel is still in trouble, textiles are threatened, and the mining and petroleum sectors remain soft. In spite of the fact that the majority of new and existing firms have not used the ITC, investment and growth in small firms has been phenomenal over the period of its effect. How can this be explained?

If recent economic growth can be attributed to any one factor, it is to the reduction in rates afforded in 1981. Using this as a guideline, it is reasonable to conclude that the repeal of ITC and the stretch-out of depreciation would have a negative economic impact on some firms in a few industries, but the general reduction in rates would have a net positive effect on the broad majority of firms. The House proposal would increase retained earnings for most firms, while reducing economic distortions created by artificial tax incentives. This would free capital to flow based on economic considerations and not tax ones, thereby improving market efficiency and stimulating growth.

Specific Small Business Issues

Within the context of tax reform, several issues are important to small business. The following is a list of those issues which we believe will assist the broadest number of small firms and result in tax relief, paperwork relief, and regulatory relief for the small business owner.

Individual Rates

A primary goal of tax reform is fairness and economic growth. In the minds of many owners of small businesses, especially unincorporated small businesses, these goals are achieved by reductions in marginal tax rates. For the millions of small businesses operated as sole proprietorships or partnerships, there is only one way to achieve any tax relief i.e. rate reductions.

The bulk of unincorporated small businesses tend to be service or retailing establishments. For them, the issues of depreciation and capital gains are not important. Nor can reform for these types of businesses be framed in terms of equity financing or accounting methods issues. The only type of tax reform that helps these small businesses is tax rate reductions, because reductions promote capital retention.

All too often tax policy planners assume that small business owners view their business profits as disposable income. It was never considered that these small business owners might actually be business planners as well as consumers. Our research reveals that the bulk of small business growth is financed not from equity capital, but from internally-generated earnings.

This point is further illustrated by NFIB's Quarterly Economic Report, which surveys NFIB members on their current economic situation. Over the last year, the QER has consistently showed increased levels of investment in capital equipment and inventories by NFIB members. Over this same time period, the frequency of borrowings declined. This means that an increasing amount of investment and growth by small businesses is being generated by earnings growth, the least expensive kind of capital formation policy because it treats all individuals the same.

Reductions in marginal tax rates are therefore critical to small business, and there is also significant support for a reduction in the number of tax brackets for individuals. Limiting the number of brackets enhances equality of taxation and provides tax relief.

Graduated Corporate Rates

The graduated tax for small corporations continues to be among the more positive changes in tax policy, resulting in tax relief and growth among many small corporations.

The graduated corporate income tax is not a tax dodge or a device for sheltering the income of wealthy professionals. In 1975, 1978, and 1981, graduation of corporate tax rates was approved and enacted by Congress for the following reasons (among others):

> The bulk of incentives in our tax laws applies to capital-intensive firms (through depreciation and are investment tax credit); a corporate rate graduation applies to all firms, especially the great majority of small firms, who are inventory and labor intensive.

> A corporate rate cut reduces the effective cost of capital and assists in attracting investment capital into small business, thereby reducing the bias towards debt financing. While depreciation and the investment tax credit accomplish the same objectives, they are only effective for capital-intensive firms. However, the benefits of graduation are targeted directly to small firms, and the impact of a flat corporate rate would be equally direct.
>
> (Excerpts of a report on "Tax Policy and Capital Formation," prepared by the staff of the Joint Committee on Taxation.)

Currently some 75% of all corporations fall within the class of firms benefitting from graduation. They are allowed the opportunity to retain earnings at a lower tax rate and to use these earnings to buy inventory, expand capacity, and hire new employees. The House tax reform proposal recognizes the prime importance of graduated corporate rates to small business, and addresses this need by providing for reductions in graduated rates. Unfortunately the rate reductions proposed are not uniform in their impact for corporations with $25,000 of taxable income or less receive no rate cuts, while large firms are receiving a 30% rate reduction.

Inventory Accounting

Inventory accounting rules, while among the most arcane subjects within the Internal Revenue Code (IRC), are very important to retailers and wholesalers. If a firm is using the wrong accounting method, taxes will be paid on "paper profits" (e.g.--"increase in the sales price of goods and services due entirely to inflation.") This situation becomes especially acute during periods of high inflation when the nominal value of inventory is rapidly increasing. Increases in the nominal value of inventory result in taxes being paid on inflated values for goods still sitting on the shelves of the store. This reduces cash flow and impedes the growth of the business.

The House proposal includes provisions for simplification of the "Last-In-First-Out" (LIFO), method of inventory accounting, used by firms with sales of less than $5 million annually. This proposal is a major step forward in the simplification of inventory accounting methods and we would hope that the Senate Finance Committee would agree to include this proposal in its tax reform document.

Payroll Tax Deposit Rules

Payroll tax deposit rules, mandating the frequency with which deposits of Social Security taxes and withheld federal taxes must be deposited, can impose excessive paperwork and regulatory burdens on a small business and limit cash flow that might otherwise be working for the business. Legislation should be enacted to ensure that small firms do not have to make payroll tax deposits more frequently than monthly. This can be done by amending the regulations under section 31.6302 (c)-1(B) of the Internal Revenue Code to change the threshold from $3,000 to $5,000 for going from monthly payroll tax deposits to eight monthly payroll tax deposits. This change would greatly help to ease the paperwork burden on small firms and would likely help reduce the high percentage of penalty assessments on small firms.

Depreciation for Small Firms

Depreciation rules for small business need to be kept as simple as possible to ensure that smaller firms are not faced with a new array of confusing choices in depreciation. Direct expensing of investments by small business would be very helpful to small firms by relieving them of a constant recordkeeping headache and by helping to relieve their cash flow problems. An annual expensing allowance for purchases of trucks or machinery and equipment would relieve this problem for the majority of smaller firms. Depreciation recapture in the case of a full expensing option should provide that proceeds from the sale of assets are taxable when sold, as in current law.

The depreciation proposal in HR 3838 operates on several levels, and it is important to recognize the changes it makes. The House measure first proposes to increase to $10,000 the amount of assets which can be expensed annually. However, this provision will only be available for firms with depreciable machinery and equipment valued less than $200,000.

For all other assets a system of ten asset categories would be established that would result in changes in useful lives for almost all assets. However, as compensation the rate of depreciation is accelerated from 150% of declining balance to 200% of declining balance. This means that, while the useful lives are longer, the asset is depreciated faster because the early years will carry the bulk of the depreciation benefits. What this means for assets such as a car is that depreciation benefits will probably be close to that they are now. (For most machinery and equipment, the increased change in the depreciation schedule will offset the changes in the useful lives.

The major difference will remain the loss of the investment tax credit and its impact on small corporations and, especially, small capital intensive corporations. In this context we believe that the impact of the loss of the investment tax credit on small capital intensive firms with incomes of less than $50,000 is disproportionate and may result in actual tax increases. Several solutions are available to rectify this problem. One would be to require that the amount which can be expensed be increased to $25,000 rather than the $10,000 amount in the House bill, or to futher reduce tax rates. Clearly large firms are receiving rate reductions sufficient in most cases to offset the changes in depreciation.

Health Insurance Deduction for Self-Employed Business Owner

An employer is permitted to furnish health insurance coverage for employees as a non-taxable fringe benefit. The cost of the insurance is a tax deductible cost to the business and is not taxable as income to the employee. Owners of small corporations are also treated as employees for many tax purposes, therefore the cost of health insurance is a non-taxable benefit to the owner. However, the self-employed business owner is not considered an employee for tax purposes. The cost of health insurance for the self-employed owner is not deductible as a business expense and is considered taxable income.

Differing treatment of fringe benefits due to the legal form of the business is unfair to owners of millions of unincorporated small firms. The conditions under which corporate and unincorporated business operate and function are equivalent for most purposes except for the corporate level tax. Decisions on which legal form to adopt should be neutral from a tax perspective.

Legislation should be enacted to amend the Internal Revenue Code to allow a self-employed business owner who is providing health insurance for his firm's employees to take a business deduction for the cost of the owner's health insurance.

Including the IRS Under the Provisions of the Regulatory Flexibility Act

The Internal Revenue Service has claimed to be exempt from the provisions of the Regulatory Flexibility Act (P.L. 96-354). Yet the IRS, in implementing tax policy and collecting revenues, imposes innumerable regulatory and paperwork requirements on significant numbers of small firms every year.

The Regulatory Flexibility Act was intended to include all departments and agencies within its provisions. The purpose of the Act was to require departments and agencies to analyze the impact of proposed regulatory activities on small business and to tailor, whenever possible, alternative regulatory and paperwork requirements to fit the resources of small firms. The objective of the analysis and development of alternatives was to encourage agencies to adopt the least onerous approach to rulemaking without sacrificing legitimate policy concerns.

In attempting to provide unquestioned legitimacy to regulatory flexibility, the Act was incorporated as a new chapter in the Administrative Procedures Act (APA) to ensure that the small business impact would be given due consideration in the normal rulemaking process, as opposed to being treated as an exceptional circumstance. Unfortunately, the APA covers most, (but not all) types of rulemaking, thereby creating a loophole never intended by

Congress. IRS, for example, claims to be exempt because the APA does not require public notice and comment on "interpretive" rules, and IRS rules for the most part are merely interpretations of tax policy as passed by Congress.

The Senate Judiciary Committee's report on the Regulatory Flexibility Act included the statement: "The Committee believes that government-wide, enforceable, and coordinated with the legislative framework for the agencies." Clearly the Congressional intent was to require all agencies and departments to comply with the RFA. *****

Legislation should be enacted to require that all IRS rules and regulations which have an impact on small business are to be developed and implemented in accordance with the provisions of the Regulatory Flexibility Act.

Attorneys Fees and the IRS

A state of confusion and controversy exists as to whether recovery of attorneys fees and courts costs should be allowed in Tax Court cases and, if so, under what standard and in what amounts.

The Equal Access to Justice Act, passed in 1980, did not allow for recovery of attorney fees and court costs by prevailing individuals or small businesses in cases litigated in Tax Court; (tax cases litigated in the Court of Claims were covered.)

Motivated by a sincere effort to rectify the anomalous situation between the Tax Court and Court of Claims, the 1982 tax bill, TEFRA, added a new section to the Internal Revenue Code authorizing awards of court costs and fees to prevailing private parties in both Tax Court and Court of Claims proceedings.

Unfortunately, this change stirred up quite a controversy. While inclusion of Tax Court cases under any fee-shifting statute was infinitely preferable to an exemption, small business groups would have much preferred coverage under EAJA. More importantly, the TEFRA language is substantially different than EAJA: the burden of proof is on the taxpayer, not the IRS; the standard under TEFRA for the position of the U.S. is a reasonableness standard, which is significantly easier for the U.S. to measure up to than is the EAJA standard of "substantial justification"; and the TEFRA language sets a maximum cap of $25,000 on awards; EAJA does not limit total awards, but it does set a $75/hour limit on attorneys fees. To further complicate matters, the TEFRA provision is subject to the appropriations process for implementation. As there have been no appropriations, there have been no awards.

During the long fight in the 98th Congress over reauthorization of EAJA, the Tax Court issue was a central focus. Not until the final hours of the session was compromise language worked out by staff on the Judiciary and Finance Committees.

NFIB members have voted overwhelmingly in support of across-the-board recovery of attorney fees and court costs by prevailing parties in civil actions involving the government.

Other Concerns

There are several other issues which were raised in the Treasury and House tax reform proposals which remain of concern to us, even though most of these issues were adequately resolved in the House tax bill. Specifically the provisions of concern are:

*Retaining availability of the cash method of accounting;

*Retaining use of the completed contract method of accounting for small firms;

*Resisting any new changes to pension rules which make it more difficult for small business owners to establish or maintain plans;

The most important issue which the House and Treasury reform proposals address, is that there is no need for any new taxes. In this context, raising taxes or instituting new taxes to promote tax reform will result in massive opposition to such a tax reform proposal. Specifically, any type of Value Added Tax would be considered ill-advised tax policy.

Conclusion

Thank you once more for allowing me the opportunity to appear before you today. NFIB is anxious for tax reform to occur and we are anxious to see that the Senate begins to become aware of the strong cross industry support for tax reform, and specifically the strong small business support for tax reform. We are confident that if you stop to look at the facts, you will be convinced that the outline presented in HR 3838 is favorable to small business. Although some modifications such as I have described should be made, HR 3838 is a solid basis for beginning the debate.

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Profile of Small Business

A. By Business Form:

	NFIB Membership	Total Number of Business Establishments (employers) in the U.S. *
Corporations	275,458 (53%)	2,270,716 (48%)
Unincorporated	244,274 (47%)	2,453,000 (52%)
Total	519,732	4,723,716

B.	NFIB Membership By SIC Code	National Small Business Population By SIC Code*
Retail	30%	31%
Service	28%	29%
Wholesale	8%	11%
Total Non-capital intensive	66%	71%
Manufacturing	13%	10%
Construction	13%	12%
Agriculture	5%	2%
Transportation	3%	4%
Total capital intensive	34%	28%

C. Small Business by Gross Sales**

Less than $50,000	8%
$50,000 - 99,999	12%
$100,000- 199,999	15%
$200,000-349,999	14%
$350,000-799,999	18%
$800,000-1,499,999	13%
$1,500,000-2,999,999	8%
$3,000,000- or more	9%
Not Responding	2%

D. Small Business by Number of Employees**

1	7%
2	11%
3-5	27%
6-9	20%
10-14	12%
15-19	5%
20-39	9%
40 or More	8%
Not Responding	1%

E. By Investment**

55% Invest

45% don't invest (on a regular basis)

F. Investment By $ Volume (of 55% who invest regularly)**

under $1,000	7%
$1,000 to $4,000	19%
$5,000 to $9,000	15%
$10,000 to $19,000	23%
$20,000 to $49,000	18%
$50,000 to $99,000	8%
$100,000 to $499,000	8%

64% below $19,000

G. Investment By SIC Code (of those who invest regularly)**

	Under 10K	Under 20K
Services	70%	82%
Agriculture	67%	80%
Retail	76%	87%
Wholesale	66%	78%
Transportation	55%	62%
Manufacturing	52%	67%
Construction	58%	76%

*Source: The State of Small Business, A Report of the President, May, 1985

**Source is the NFIB Quarterly Economic Report, Published by the NFIB Education and Research Foundation. This report has been published for forty nine consecutive quarters and is recognized as a reliable forecaster of national economic trends.

Selected Survey Information On Taxes

Tax Priorities

A. From 1981 Survey*:

	Priority Tax Cut Areas Very High	High	Total
Individual Rates	70%	21%	91%
Estate Taxes	57%	27%	84%
Payroll	55%	28%	83%
Depreciation	53%	34%	87%
- just capital intensive	63%	7%	70%
Corporate Rates	50%	27%	77%
- just corporations	68%	24%	92%

B. From Late 1984 Survey*

1. Preferred Tax Cut Areas

Individual rates	53%
Payroll	26%
Corporate	9%

2. Preferred Preferances

Home mortgage interest	72%
State and local taxes	47%
Charitable Contributions	41%
Personal Exemption	36%
ACRS	27%
ITC	27%
Graduated Corporate Rates	22%

Attitudes Toward Tax Reform

A. From Late 1984 Survey

1. Congress should lower taxes eliminate deductions ...	51% agree
2. Current tax code too complicated	87% agree
3. Flat and modified flat tax a good idea ...	62% agree
4. 25% flat tax	53% no
5. 25% modified flat tax, keeping personal exemption, chartible and home mortgage deductions	62% yes

B. From Membership Sampling:

Given a choice between current law and the President's tax reform proposal, which do you prefer?

77% President   21% Current law   2% undecided

*In addition to NFIB polls of its entire 500,000 members, detailed surveys are performed on a randomly selected scientific sampling of the whole membership.

The CHAIRMAN. Thank you very much.

Our last witness on this panel is Mr. Roger Vail, representing the National Retail Merchants Association.

STATEMENT OF ROGER S. VAIL, PRESIDENT, FRED W. UHLMAN & CO., BOWLING GREEN, OH; REPRESENTING THE INDEPENDENT STORES DIVISION OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION

Mr. VAIL. Good morning, Senators. My name is Roger Vail. I'm president of Fred W. Uhlman & Co. located in Bowling Green, OH. Today I am here to testify as chairman of the board of directors of the Independent Stores Division of the National Retail Merchants Association.

By way of quick background, NRMA is the Nation's largest trade association for the general retail industry. Our members operate 45,000 leading department store chains, independent and specialty stores in all 50 States and their sales exceed $175 million, and they employ more than 3 million workers.

When I appeared before this committee on this date last year during the committee's oversight hearings on general issues of concern to small business, my testimony focused on tax reform and its implications for the Nation's independent retailers. I'm gratified, therefore, that today the committee's hearing is devoted exclusively to tax reform since it remains one of the highest priorities for general merchandise retailing and of acute concern to the independent retailers.

Within the context of tax reform I will address two issues: One, the retention and improvement in the graduated corporate tax rate and, second, an improved means of inventory evaluation. Both have been include in H.R. 3838, the Tax Reform Act of 1985, which was approved by the House of Representatives and sent to the Senate during the closing days of the first session of this Congress.

NRMA's interest in small business tax reform issues was reactivated with the release of the Treasury Department's November 1984 report on fundamental tax simplification and reform. The Treasury report proposed indexing of inventories by an inventory accounting method known as the FIFO indexing, a principle strongly supported by independent retailers. However, the Treasury report also proposed the elimination of the graduated corporate income tax rate system on which small business depends.

The elimination of the graduated corporate tax rates would dramatically increase the small business retailer's effective tax rate and reduce essential capital available for continued operation and growth. Small businesses with less than $150,000 of taxable income would face a significant tax liability increase should the graduated taxes be eliminated. Under the Treasury Department's proposal, a firm with $50,000 or less in taxable income would be hit with 100 percent increase in taxes while a firm with $50,000 to $150,000 in taxable income would face a smaller, but nevertheless significant, tax increase. Small business retailers use retained earnings as an important source of operating and expansion capital. Without access to capital, a small business retailer faces a difficult, if not insurmountable, hurdle in starting and expanding a business.

Now let me explain for a minute while inventory valuation is so important to small retailers. While inventory accounting rules are very technical and complex and have attracted a minimum of public interest, the tax policy behind inventory valuation affects the equitable tax treatment of inventory-intensive industries such as retailing. For inventory-intensive business the choice of one inventory evaluation accounting method over another can have a significant impact on the amount of taxes paid during an inflationary period.

As you are probably aware, there are two primary inventory accounting methods: the FIFO or first-in, first-out method assumes that goods purchased first are sold first. Under this method the most recently purchased goods are deemed to exist at the end of the year. This means that the ending inventories will be valuated at the most recent purchase cost. With an ending inventory at a higher value, assuming there is some inflation, the cost of goods sold is lower, the gross income is higher, and resulting in more taxes paid on paper profits.

The LIFO or last-in, first-out accounting method assumes that the last goods purchased are the first sold. Under this alternative method the ending inventory will be valued at the oldest purchase cost, resulting in higher costs of goods and lower gross income than that realized under FIFO. Therefore, selection of this inventory accounting method can result in a significant reduction in taxes paid.

Initially, the LIFO inventory valuation method was created in response to the recognition of inflation's impact on inventory valuation. As stated in the President's tax proposal, about two-thirds of inventories in the United States are owned by firms which continue to use the FIFO accounting method, despite the overstatement of income tax liability during inflationary times. Many small businesses are reluctant to use the LIFO method because LIFO is regarded as significantly more complex than FIFO. An FTC study concluded that the LIFO compliance costs are proportionately higher for small businesses than for larger firms, which has put small businesses at a competitive disadvantage during inflationary times.

The bill approved by the Ways and Means Committee and the full House permitted certain small businesses with $5 million in annual gross receipts or less to use a simplified dollar value LIFO method of accounting for valuing their inventories. This method requires inventories to be grouped in pools in accordance with the major categories of the Producer Price Index or the CPI detailed report. The change in inventory costs for the pool for the taxable year is determined by the change in the published index for the general category to which the pool relates. This simplified dollar value LIFO method requires the use of multiple pools in order to avoid the construction of a weighted index specific to the taxpayer. Rather than constructing the index, the annual change in the costs for the pool as a whole is measured by the change in the published index for the general category.

The Ways and Means Committee and the House of Representatives also approved a new graduated rate structure which provides for a 15-percent corporate income tax rate on taxable income up to $50,000, a 25-percent rate on income between $50,000 and $75,000, and a 36-percent rate on taxable income over $75,000. NRMA's independent retail members view this as a major improvement over the current law because it provides reasonable rate reduction at the lower end of the scale which will allow us to better be able to compete in our industry.

Moreover, I expect that the retention and improvement in the graduated rate structure, which is beneficial to the small business community in general, should be a major force, if not a primary element, that draws strong support from the small business community. As both of these measures and other small business tax reform issues are reviewed by this committee and the Senate Finance Committee during its markup, I would suggest the members of this committee support the retention and improvement in the graduated corporate income tax rates and the improved inventory valuation accounting method as approved by the House of Representatives last December.

Unless there are any other questions from the committee members or staff, this concludes my statement. I would thank the chairman and the members of this committee for the opportunity to testify.

[The prepared statement of Mr. Vail follows:]

STATEMENT
OF
ROGER S. VAIL
PRESIDENT, FRED W. UHLMAN & COMPANY
ON BEHALF OF THE
NATIONAL RETAIL MERCHANTS ASSOCIATION
BEFORE THE
SENATE SMALL BUSINESS COMMITTEE
FEBRUARY 6, 1986

Good morning. My name is Roger Vail. I am President of Fred W. Uhlman & Company, located in Bowling Green, Ohio. Today I am here to testify as Chairman of the Board of Directors of the Independent Stores Division of the National Retail Merchants Association.

By way of background, NRMA is the nation's largest trade association for the general merchandise retail industry. Our members operate 45,000 leading department, chain, independent and specialty stores in all 50 states. Their annual sales exceed $175 billion and they employ more than 3 million workers. The vast majority of NRMA's members are small, independent retailers whose annual sales are less than $1 million. Our Independent Stores Division represents the fastest growing segment of our membership.

When I appeared before this Committee on this date last year, during the Committee's oversight hearings on general issues of concern to small business, my testimony focused on tax reform and its implications for the nation's independent retailers. I am gratified, therefore, that today the Committee's hearing is devoted exclusively to tax reform, since it remains one of the highest priorities for general merchandise retailing and of acute concern to independent retailers. Within the context of tax reform, I will address these two issues: (1) the retention and improvement in the graduated corporate tax rates and, (2) an improved means of inventory valuation. Both have been included in H.R. 3838, the Tax Reform Act of 1985, which was approved by the House of Representatives and sent to the Senate during the closing days of the first session of this Congress.

NRMA's interest in small business tax reform issues was reactivated with the release of the Treasury Department's November, 1984, Report on Fundamental Tax Simplification and Reform. This report, which recommended numerous changes in the Internal Revenue Code to promote fairness, simplicity and economic growth, was generally supported by much of the general merchandise retail industry. Changes which would have a direct impact on independent, small business retailers were also included in the Department's report. Specifically, the Treasury report proposed the the indexing of inventories by an inventory accounting method known as FIFO indexing, a principle strongly supported by independent retailers. However, the Treasury report also proposed the elimination of the graduated corporate income tax rate system on which small business depends.

The elimination of the graduated corporate tax rates would dramatically increase the small business retailer's effective tax rate and reduce essential capital available for continued operation and growth. Small businesses with less than $150,000 of taxable income would face a significant tax liability increase should the graduated rates be eliminated. Specifically, under the Treasury Department's proposal, a firm with $50,000 or less in taxable income would be hit with a 100 percent increase in taxes while a firm with $50,000 to $150,000 in taxable income would face a smaller, but nevertheless significant, tax increase. Small business retailers use retained earnings as an important source of operating and expansion capital. Without access to capital, a small business retailer faces a difficult if not an insurmountable hurdle in starting and expanding a business.

Recently, the importance of the availability of capital for small businesses was confirmed in a survey of 209 mayors from cities with 30,000 or more in population in 44 states and Puerto Rico on local, state, and federal issues affecting small business. A majority of the mayors had direct personal experience in small business as owners, employees or both. The study concluded that the availability of capital is the number one problem facing small businesses. This study confirms NRMA's own analyses.

The year-long process of drafting a tax reform bill has placed small businessmen and women on a legislative seesaw. In May, 1985, President Reagan released his tax reform proposal to the Congress. Contrary to the Treasury Department's report, the President's proposal retained the corporate tax graduated rates and, in line with the prior Treasury recommendation, continued to call for FIFO indexing. Independent retailers were concerned by the lack of rate reduction at the lower corporate income brackets but realized that FIFO indexing would be beneficial. However, our interest and support for tax reform diminished when the President's amended proposal deleted the FIFO indexing concept. The small business retailer's opposition to tax reform increased after House Ways and Means Committee Chairman Dan Rostenkowski (D.-Ill.) released his staff options paper. That document, which was to be used for the Committee's markup, did not contain an improved inventory valuation method. Moreover, the staff options broadened the tax base in return for rate reduction at the upper end of the scale yet failed to provide proportionate rate reductions for the smaller retailer with taxable income at the lower end of the scale.

NRMA urged the Committee to modify the staff options to include an improved method of inventory valuation (i.e., FIFO indexing or the establishment of a simplified LIFO system which is practical for small business) and to improve upon the graduated rate structure so that the small business retailer would receive a proportionate rate reduction and thereby improve his competitive position in the marketplace. Without meaningful changes in these two areas, we saw little in tax reform for our small business members to support.

Let me explain for a minute why inventory valuation is so important to small retailers. While inventory accounting rules are very technical and complex and have attracted minimum public interest, the tax policy behind inventory valuation affects the equitable tax treatment of inventory-intensive industries such as retailing. For an inventory-intensive business, the choice of one inventory valuation accounting method over another can have a significant impact on the amount of taxes paid during an inflationary period.

As you are probably aware, there are two primary inventory accounting methods. The FIFO, or first-in, first-out, method, assumes that goods purchased first are sold first. Under this method, the most recently purchased goods are deemed to exist at the end of the year. This means that ending inventories will be valued at the most recent purchase cost. With ending inventory at a higher value (assuming some inflation during the period), the cost of goods sold is lower, and gross income is higher, resulting in more taxes paid on paper profits.

The LIFO, last-in, first-out, accounting method, assumes that the last goods purchased are the first sold. Under this alternative method, the ending inventory will be valued at the oldest purchase cost resulting in higher costs of goods and lower gross income than that realized under FIFO. Therefore, selection of this inventory accounting method can result in a significant reduction in taxes paid.

Initially, the LIFO inventory valuation method was created in response to the recognition of inflation's impact on inventory valuation. As stated in the President's tax proposal, about two-thirds of inventories in the United States are owned by firms which continue to use the FIFO accounting method, despite the overstatement of income tax liability during inflationary times. Many small businesses are reluctant to use the LIFO method because LIFO is regarded as significantly more complex than FIFO. A 1984 Federal Trade Commission Bureau of Economics study confirms this, indicating that the "(r)easons cited prominently by small firms for continuing to use FIFO include the costs of complying with LIFO regulations and uncertainties about the application of LIFO regulations." The FTC study concludes that the LIFO compliance costs are proportionately much higher for small businesses than for larger firms, which has put small businesses at a competitive disadvantage during inflationary periods.

The FIFO indexing proposal was deleted from the President's proposal allegedly for revenue-neutrality reasons. It was subsequently rejected by the Ways and Means Committee for this and other technical reasons. Instead, the bill approved by the Committee and the full House permitted certain small businesses with $5 million in annual gross receipts or less to use a simplified dollar-value LIFO method of accounting for valuing their inventories. This method requires inventories to be grouped in pools in accordance with the major categories of the "Producer Price Index" or the "CPI Detailed Report." The change in inventory costs for the pool for the taxable year is determined by the change in the published index for the general category to which the pool relates. The simplified dollar-value LIFO method requires the use of multiple pools in order to avoid the construction of a weighted index specific to the taxpayer. Rather than constructing the index, the annual change in costs for the pool as a whole is measured by the change in the published index for the general category.

The Ways and Means Committee and the House of Representatives also approved a new graduated rate structure which provides for a 15 percent corporate income tax rate on taxable income up to $50,000, a 25 percent rate on income between $50,000 and $75,000, and a 36 percent rate on taxable income over $75,000. NRMA's independent retail members view this as a major improvement over current law because it provides reasonable rate reduction at the lower end of the scale which will allow us to better be able to compete in our industry. Moreover, I expect that the retention and improvement in the graduated rate structure, which is beneficial to the small business community in general, should be a major force, if not the primary element, that draws strong tax reform support from the small business community. As both of these measures and other small business tax reform issues are reviewed by this Committee and the Senate Finance Committee during its markup (which is now tentatively scheduled to begin in early March), I would suggest members of this Committee to support the retention and improvement in the graduated corporate income tax rates and the improved inventory valuation accounting method as approved by the House of Representatives last December.

Unless there are any questions from Committee members or staff, this concludes my statement. I would like to thank the Chairman and members of the Committee for the opportunity to testify.

The CHAIRMAN. I only have one question and it will be the same really to all those who appear. If Dale or Senator Sasser have further questions, they may proceed.

Mr. Fairbanks, bill or no bill? Do you want a bill, a tax reform bill, or no bill?

Mr. FAIRBANKS. We would have to take a look at the final bill that came out as tax reform. We support the concepts of tax reform. We support individual rate reductions.

The CHAIRMAN. Let me be specific with everybody, so that you have a choice. You can't speculate on a Senate bill because we haven't seen that.

House bill or no bill?

Mr. FAIRBANKS. If the Senate passed the House bill in the same form that it is now, the position of SBU would be that we would oppose the bill in its entirety as not being a satisfactory improvement over present law.

The CHAIRMAN. Mr. Schneier.

Mr. SCHNEIER. Senator, we support the efforts at tax reform and we believe that the tax reform should be passed during this Congress. We would support H.R. 3838 over present law.

The CHAIRMAN. Mr. Vail.

Mr. VAIL. In answer to your question directly, we would support the House-passed bill, 3838.

The CHAIRMAN. OK. Thank you.

Senator Bumpers.

Senator BUMPERS. Gentlemen, we are getting conflicting reports. We are getting reports from some small business people, particularly members of NFIB, wholesalers and distributors, who seem to support the bill, as you've just stated, and then we are getting almost a corresponding number of letters from people who oppose it. It leaves me personally—and I think to some extent I speak for my colleagues on this committee—in a little bit of a quandry.

Frankly, I would not have voted for the bill over in the House, even though I think generally it is good for small business. But one of the things I have about concluded—and I would ask for your comments on this—it's good if you are a small business and in need of investment capital, and it isn't particularly good if you don't; is that a fair statement or not?

Mr. **Fairbanks**. We feel, Senator, that the capital-intensive companies are going to be hurt by this bill in general.

Senator **Bumpers**. I think I said that backwards, didn't I?

Mr. **Fairbanks**. I think you did.

Senator **Bumpers**. I'm sorry. Well, just reverse the question, then. [Laughter.]

Mr. **Fairbanks**. Well, we feel the bill is anti-investment and anti-savings. So in order to encourage investment and savings we're advocating the retention, at least partial retention, of ITC and ACRS.

Mr. **Schneier**. Senator, there probably are certain small capital-intensive industries which have a problem with the capital formation incentives as detailed in H.R. 3838, and I think some addressing of those issues probably is warranted.

However, it is also certainly true that the ability to recover your investments strictly based on the investment tax credit and depreciation is not the sole factor that is a small business uses to determine investment. Return on investment and other factors come into play such as market capabilities, the ability to turn profits, the ability to recognize market expansion in the future.

We feel that it is quite possible, as some people have said in 1981, maybe we went too far in terms of the capital formation incentives. Of course, at that time nobody was offering a 10-point rate reduction on the top end of the corporate rate structure and nobody was offering individual rate reductions as low as we have it today.

But we believe that some middle ground probably needs to be found.

Senator **Bumpers**. I forget—is the investment tax credit phased out under this bill over some period of time?

My staffer says it's an outright repeal.

I certainly think anything is going to be more palatable than outright repeal—remember, we used to have a 7-percent investment tax credit and then we went to 10 percent. Would it make more sense, given the fact that if we are going to meet the personal income tax cuts, we've got to raise more money someplace else to make it revenue neutral, would it make any sense, for example, instead of an outright repeal, to reduce the investment tax credit, say, to 6 percent over a 4-year period, drop it 1 percent a year?

It certainly would seem to me as though, if we are going to do anything with ITC, that would eliminate some of the upheaval that an outright repeal might cause. Does that make any sense?

Mr. **Schneier**. Like you say, the tradeoff is the difficult part. Where do you get the money for it? If it were to paid for by increasing the rates, I think we would have a problem with that.

Senator **Bumpers**. Let me ask one final question of all of you. Are you all of you unalterably opposed to any tax bill that raises revenues? Do you agree with the President—never?

Mr. **Fairbanks**. The position of Small Business United is that the tax bill should be revenue neutral. Of course, the chairman——

Senator **Bumpers**. I'm asking you a question dealing with deficits, which is the overwhelming, No. 1 domestic issue in the country.

Mr. **Fairbanks**. Right. I was going to address the question that the chairman raised in his written opening statement, which is, to paraphrase the question: Which is more important, deficit reduction or tax reform? In the view of Small Business United, we feel that the deficit reduction problem comes first as opposed to tax reform. Our feeling also, with respect to deficit reduction, is that there are a lot of areas where spending can be reduced. In our view this includes social security; this includes the defense as well as other budget areas. We see no reason that social security or defense should be off limits from significant budget reductions and expense reductions.

Senator **Bumpers**. Would either one of you gentlemen like to comment on that?

Mr. **Schneier**. From NFIB's perspective, we also believe the deficit is the No. 1 problem. However, we would not want to see the tax reform package held hostage to that situation, and we would not want to see tax reform killed by turning it into a tax increase proposal.

We would have some problems with tax reform if it were used to increase taxes. As some might say, it's already doing that through the alternative——

Senator **Bumpers**. How about an oil import fee? Would you be opposed to that?

Mr. **Schneier**. At this point in time I couldn't say.

Senator **Bumpers**. Mr. Fairbanks, just quickly, do you oppose an oil import fee?

Mr. **Fairbanks**. We have no position on that, Senator. We would consider it in SBU.

Senator **Bumpers**. OK.

Mr. **Vail**. Senator, I would like to address the question of which is more important, tax reform or budget deficit. I would just put to the record that really there are two parts which should be addressed separately. The budget deficit is a current management problem with long-term implications and should be addressed as such, as we would in our businesses. The second part is tax reform, which is really a long-term issue which affects the rules in which we do business and how we compete in a world economy.

I think we're looking too shortsighted on both of these. They have to be together.

Senator **Bumpers**. Well, the President, as you know, has said essentially, "Why don't you guys do something, but you can't touch Social Security; you can't cut defense; and you can't raise taxes."

You will admit that he reduces our options very considerably with that, wouldn't you?

Let me just ask you: If you were in my position and the President was telling you that 65 percent of the budget is off limits and you can't do anything to raise taxes, how would you deal with it? There are seven things—if you take Social Security, Medicaid, Medicare, civil service pensions, military pensions, interest on the debt, and defense—just to fund those 7 out of 500 Government functions produces a $20 billion deficit. How would you deal with it?

Mr. VAIL. I'll go first this time.

A management technique, as you start to get all the things moving in the right direction——

Senator BUMPERS. Let me make one other point. Of the 500 functions of Government, if you just fund those 7, don't cut but totally eliminate the other 492—take away school lunches, student loans, the court system, Congress, eliminate Washington, DC, eliminate everything—you've still got a $20 billion deficit. [Laughter.]

Mr. VAIL. Well, two premises: First, I doubt if anything like that is really cast in stone. I think if you've got all the elements moving in some degree in the right direction, it could be brought sometime down the road to a balanced budget. I think there has to be some negotiation, and that's part of the whole process. But I think you've got to get everything moving the right way, some more than others.

Mr. SCHNEIER. Senator, I would agree with you. I think including Social Security reduction as a part of the deficit budget package, taking that major piece out of the puzzle certainly makes your job a lot more difficult. I'm afraid I wouldn't begin to tell you where to go at this point. I don't think I've had time to fully evaluate that.

Senator BUMPERS. Mr. Fairbanks, do you want to say anything more?

Mr. FAIRBANKS. I think the comments that I made earlier are still applicable. SBU feels that there can be reductions adn that there should be reductions in social security and defense. We're not accepting the President's statement that those are absolutely off limits. In our view, we think the Senate and the House should investigate those possibilities.

Senator BUMPERS. Let me say that I held hearings on behalf of this committee all over my State last summer, and among the farm community and small business community there really was not much enthusiasm for tax reform because those small business people out there think of tax reform in terms of, No. 1, fairness and, No. 2, simplicity. This bill doesn't meet their criteria on either one of those counts.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you very much.

Are there any further questions at this point?

Senator SASSER. I have one or two questions, Mr. Chairman.

Gentlemen, based on your statements and comments that have been made by those who have been associated with your organizations in the past, I know that you share my concern about graduated corporate tax rates. Many argue that corporate rate cuts will increase equity investment. I think that logic ought to extend to small business firms as well.

I propose setting a rate of 12 percent on corporate income up to $25,000 and 15 percent for income between $25,000 and $50,000. What are your thoughts about appropriate graduated corporate rates for both large and small business? Should there be a differential in those rates?

Mr. **Fairbanks**. SBU would favor those rates. As I understand the present law, and I believe H.R. 3838, there is a phaseout of the corporate rate reductions above a certain level. I'm not sure what that is. But, effectively, a large corporation pays the full maximum rate. We favor the reduction at the lower end.

Mr. **Schneier**. Senator, we certainly would support further reductions in graduated rates. Again, the difficulty is where to find the money, but, as we all know, the benefits of graduated rates are specifically targeted to small firms. They provide the capital retention and the capital they need to grow. We certainly would have no problems with that.

Mr. **Vail**. As we all know, the small business sector is the generator of jobs. When you go down to making $12,000 a year or losing $12,000, there's not much difference. Any help on that lower end would just be additional incentive and increase the probability of business success in developing. After they start to mature, they can afford to pay the going rate, if you will.

Senator **Sasser**. Gentlemen, one other quick question: Mr. Vail mentioned the question of inventory accounting rules and their importance to small business. Now just how important is cash accounting to small business firms, in your judgment? Do you want to lead off on that, Mr. Vail?

Mr. **Vail**. How important is tax accounting?

Senator **Sasser**. Well, inventory accounting rules and how important is cash accounting to small firms? You alluded to that a little earlier in your testimony.

Mr. **Vail**. Cash accounting or accrual accounting?

Senator **Sasser**. Well, inventory accounting rules. Just give us a general discussion of inventory accounting rules and how important they are to small business.

Mr. **Vail**. I think there has been a definite avoidance of small business, small retailers, to streak away from the LIFO because it's very complex, and I can speak from personal experience. It's a fairly sophisticated topic and you have to be profitable, I guess, before it becomes even a consideration.

I think it is an important issue that can affect, at least in retailing, inventory-intensive industries' profitability.

Senator **Sasser**. Well, would a reasonable rule allow for cash accounting for small businesses where the annual gross receipts are $2 million or less? Does anybody want to address that?

Mr. **Schneier**. If I might address that—the cash accounting method for a small retailer or wholesaler would be very beneficial. For small retailers and wholesalers accounting for their inventories and the method of accounting they use to deal with that is one of the more complex areas of the tax code. During periods of inflation specifically it puts them at a tremendous disadvantage and results in their paying taxes on paper profits——

Senator **Sasser**. Right.

Mr. **Schneier** [continuing]. Profits which they've never recognized, while large corporations are able to utilize the indexing methods under the LIFO proposals in the current law to eliminate the impacts of inflation on their inventory and pay a real tax liability.

We've often thought the cash method of accounting would be a good proposal for small retailers and wholesalers. We also think, however, that the LIFO simplification proposal that is in H.R. 3838 is a good approach as well.

Senator SASSER. Do you want to add to that, Mr. Fairbanks?

Mr. FAIRBANKS. Yes. SBU supports the concept of cash accounting for small business. We think the changes in H.R. 3838 are adverse, and we would like to see a fairly high limit of revenues, maybe even higher than the $2 million limit. But we certainly favor cash accounting for small business.

Senator SASSER. Thank you, gentlemen. I am advised that my time is up.

The CHAIRMAN. Are there further questions of this panel? I only want to remind the Senators here that we have a great number of panels and I want everybody to be able to be heard. I think these questions are valuable, I truly do, but just keep that in mind—that we have a long track ahead of us here.

Senator Baucus.

Senator BAUCUS. Just briefly, I apologize to the committee, but, gentlemen, as a member of the Finance Committee it is important to me to learn, very briefly, one, two, three, what are the most objectionable parts to the House bill 3838. I understand one is repealing the ITC. I understand that. If you could just outline for me just very quickly—one, two, three—so that I could focus on those, I would appreciate it.

Mr. FAIRBANKS. Well, in our view, the most critical objection to H.R. 3838 is the repeal of ITC and ACRS.

Senator BAUCUS. I must tell you, though, that in all of the discussions we have had in the committee so far there is virtually no talk about restoring the ITC. Taking that as a given, what suggestions do you have?

Mr. FAIRBANKS. You are suggesting, though, that there might be some changes in depreciation——

Senator BAUCUS. That's correct.

Mr. FAIRBANKS [continuing]. That would be more favorable.

Senator BAUCUS. That's right; liberalizing the depreciation provisions.

Mr. FAIRBANKS. That, we feel, is appropriate. Second, we feel that not changing the pension and profit-sharing rules would be——

Senator BAUCUS. The 401(k)'s?

Mr. FAIRBANKS. The 401(k)'s. They have been changed three times in the last 4 years. It's just very expensive, particularly for a small business, to keep going through the process of changing and rewriting plans. We would suggest that those not be changed.

Senator BAUCUS. We're trying on the committee to do that; that is, raise the $7,000 limit to a higher limit. That also includes the $2,000 IRA deductions in that $7,000 limit. But I must say that in doing so you have to figure out some way to make up the revenue if it is revenue neutral. There is a strong feeling on the committee anyway to restore a lot of those provisions that the House took away.

Mr. FAIRBANKS. Well, I think they are good incentives for private savings and investment. We would like to see them kept. We have proposed a possible alternative in my written testimony of a simple $12,000 cap on 401(k) deductions with no IRA offset, and not changing all of the various rules on determining what group is what group.

Senator BAUCUS. How important is it to small business to change the requirements for payroll tax deposits? I understand now the law is payroll deposits of $3,000, I guess it's on a monthly basis, that companies have to deposit up to two to eight times a month. I have suggested legislation changing that limit up to $5,000 and deposits to be only once a month, in order to reduce paperwork and reduce some of the costs of small business. How important would that change be?

Mr. FAIRBANKS. We very much advocate that. Maybe Mr. Schneier would like to comment as well.

Mr. SCHNEIER. As you are aware, we think that a very important proposal for small firms to eliminate some of the paperwork problems they are currently having with payroll taxes and raising that threshhold from $3,000 to $5,000 would go a long way toward helping that problem.

Senator BAUCUS. I'm glad to hear you say that publicly. That will help a little bit.

Mr. SCHNEIER. Also, as far as other issues which we are concerned about in H.R. 3838, I think our testimony sort of lays that out. The fact that corporations under $25,000 of taxable income, by losing the investment tax credit, may have a problem in terms of some tax increases—that issue can be addressed in some of several ways. Also, we're anxious about the alternative corporate minimum tax may for the time impact on a fairly broad constituency of small businesses that, although they may not be subject to the taxes, may still have to go through the calculations and paperwork for that.

Senator BAUCUS. I appreciate that.

Mr. VAIL. I would just add, too, the fact, assuming that ITC is gone, the earnings on the first $25,000, there's no break on that. Those are the people that would be investing in their businesses and receiving a lot of investment tax credit, which they are going to lose. If there could be something to help them or to shift it a little bit, it would be beneficial.

Senator BAUCUS. Thank you all very much.

Mr. Chairman, I have a statement for the record.

The CHAIRMAN. Your statement will be included in the record.

[The prepared statement of Senator Baucus follows:]

STATEMENT
BY
SENATOR MAX BAUCUS

SMALL BUSINESS COMMITTEE TAX REFORM HEARING
February 6, 1986

MR. CHAIRMAN, I want to commend you and Senator Bumpers for calling this hearing on behalf of Small Business and for your efforts over the last year in promoting field hearings across the nation.

I found the field hearings I conducted in my state especially helpful and I'm sure my colleagues did too.

Montana is an excellent state to listen to small businesses--it is virtually our only business. Only 13 businesses, most with headquarters outside the state, employ more than 500 people. The state's largest employer, the small retailer, averages less than 10 employees.

Small business is virtualy the only business in Montana.

But it is no less important nationally. New employment is coming virtually from the small business sector. According to the President's State of Small Business Report, all new jobs in the early 1980's came from businesses with less than 20 employees. And we know that trend continues today.

Small business also produces more than half of all new technology and innovation at about 4 percent of what it costs big business and government to produce the rest.

As a member of the Finance Committee as well as the Small Business Committee I was especially interested in what small businesses would say in these hearings. And I was impressed with the fact that they are not asking for more deductions, exemptions and special consideration.

WHAT THEY THEY WANT IS SIMPLICITY, FAIRNESS AND CONSISTENCY. AND, WHAT IS GOOD FOR SMALL BUSINESS, I FOUND, IS GOOD FOR THE NATION.

SIMPLICITY

MR. ROBERT BRAGG, A FORMER IRS AGENT, NOW AN ACCOUNTANT FOR SMALL BUSINESSES IN MISSOULA, MONTANA TOLD ME THAT,

"IN MY FORMER EMPLOYMENT WITH THE IRS AS WELL AS MY CURRENT DEALINGS WITH THE IRS, I HAVE NOTICED A MARKED CHANGE IN THE ATTITUDE OF REVENUE AGENTS. BECAUSE OF THE COMPLEXITIES OF THE LAWS AND THE ALL-CONSUMING TAX SHELTER AUDIT PROGRAMS, THE AGENTS ARE FRUSTRATED WITH THE SYSTEM. THIS CETAINLY MAKES IT DIFFICULT FOR THE ADMINSTRATORS OF OUR TAXING SYSTEM TO FUNCTION PROPERLY."

MR. CHAIRMAN, IF AN IRS AGENT IN THE FIELD LACKS CONFIDENCE IN THE SYSTEM, THEN SURELY WE CANNOT EXPECT THE TAXPAYER TO FEEL ANY BETTER ABOUT IT.

MR. JIM KOESSLER, A PRINCIPAL IN SEVERAL SMALL BUSINESSES AND CURRENTLY PRESIDENT OF ONE OF THE STATE'S FEW CAPITAL VENTURE COMPANIES, SUMMARIZED THE COST OF COMPLEXITY,

"IN MY EXPERIENCE, NEW OR SMALL BUSINESS ENTITIES ARE GENERALLY FOUNDED BY PEOPLE WHO HAVE EXPERTISE IN A PARTICULAR PRODUCT OR SERVICE, BUT OFTEN ...LIMITED BACKGROUNDS IN FINANCE OR ACCOUNTING...FIND THAT THEY ARE DEVOTING A MEANINGFUL PROPORTION OF THEIR TIME COMPLYING WITH TAX REPORTING REQUIREMENTS TO THE DETRIMENT OF THE UNDERLYING BUSINESS...OUR PRESENT TAX SYSTEM MOTIVATES AMERICAN BUSINESS TO DEDICATE SUBSTANTIAL AMOUNTS OF TIME AND MONEY TO NON-PRODUCTIVE ACTIVITIES."

FAIRNESS

IN THE WORDS OF THE FORMER IRS AGENT AND NOW ACCOUNTANT, FAIRNESS IS AT THE HEART OF MAKING THE VOLUNTARY COMPLIANCE SYSTEM WORK EFFECTIVELY. HE TESTIFIED THAT, "99 PERCENT OF THE TAXPAYERS WHOSE RETURNS I EXAMINED WANTED TO PAY THEIR FAIR SHARE OF THE TAX BILL UNDER THE LAW."

IF WE ARE TO SUSTAIN THAT VOLUNTARY COMPLIANCE, THE TAXPAYER NEEDS TO UNDERSTAND THE TAX CODE AND HOW HIS OWN TAXES ARE CALUCLATED. THE TAXPAYERS NEEDS TO KNOW IT IS FAIR.

AND, IF FAIRNESS MEANS GIVING UP A CHERISHED DEDUCTION, I THINK SMALL BUSINESS PEOPLE ARE WILLING TO GIVE THEM UP IF ALL EXEMPTIONS ARE CUT EQUALLY ACROSS THE BOARD.

IN FACT, BILL YAEGER, A YOUNG FARMER IN SOUTHEASTERN MONTANA, SAID HE WOULD BE BETTER OFF WITHOUT MANY OF THE EXEMPTIONS THAT ARE SUPPOSE TO HELP HIM.

"THE TAX CODE CAUSES NONPRODUCTIVE BUSINESS DECISIONS...THERE'S A FELLOW IN TEXAS SPENDING $50 MILLION TO BUILD A PIG FARM. I'M PRETTY SURE HE WOULDN'T GO IN THE PIG BUSINESS IF HE COULDN'T USE HIS INVESTMENT TO SHELTER SOME OF HIS OIL INCOME. I THINK IN A BUSINESS WHERE THERE'S ALREADY OVER PRODUCTION, SUCH INVESTMENT HURTS NOT ONLY THOSE OF US WHO ARE IN THE BUSINESS ALREADY, BUT HURTS THE REST OF THIS COUNTRY BECAUSE HE COULD HAVE INVESTED IN SOMETHING MORE PRODUCTIVE."

PERHAPS THE MOST URGENT PLEA, HOWEVER, IS FOR CONSISTENCY.

TIMOTHY SATHER, AN ACCOUNTANT FROM MISSOULA, MONTANA, EXPRESSED THE LACK OF PUBLIC CONFIDENCE IN THE TAX SYSTEM AS A RESULT OF THE CONSTANT CHANGES IN IT:

"WE HAD THE REDUCTION ACT OF 1975, REFORM ACT OF 1976, REDUCTION AND SIMPLIFICATION ACT OF 1977, ECONOMIC RECOVERY ACT OF 1981, EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, AND THE REFOREM ACT OF 1984. WE CANNOT STAND ANYMORE REDUCTION, REFORM, EQUITY OR SIMPLIFICATION!"

BAUCUS BILL: THE SMALL BUSINESS TAX SIMPLIFICATION AND TAXPAYER PROTECTION ACT.

MR. CHAIRMAN, AFTER LISTENING TO THE WITNESSES IN THESE HEARINGS AND AFTER SEEING THAT THE TREASURY PROPOSALS OF LAST YEAR REFLECTED LITTLE OF THEIR CONCERN, I BEGAN TO LOOK FOR WAYS TO IMPLEMENT MEASURES TO MAKE THE CODE SIMPLE, FAIR, AND CONSISTENT.

I AM, AS A RESULT OF THESE HEARINGS, INTRODUCING THE SMALL BUSINESS TAX SIMPLIFICATION AND TAXPAYER PROTECTION ACT. THESE MEASURES WILL NOT SOLVE ALL OF THE PROBLEMS, BUT I FEEL THEY ARE SIGNIFICANT STEPS TOWARD THE KIND OF REFORM SMALL BUSINESS PEOPLE WANT AND DESERVE.

PAYROLL TAX DEPOSIT ~~DATE~~ RELIEF

THE MOST SIGNIFICANT TAX FOR SMALL BUSINESS IS THE PAYROLL TAX. THIS TAX HAS INCREASED FROM ABOUT 6 PERCENT OF THE FEDERAL REVENUE IN 1946 TO ABOUT 30 PERCENT TODAY--AND SO HAS THE PAPERWORK.

ACCORDING TO A SCHEDULE ESTABLISHED BY IRS REGULATIONS, EMPLOYERS WHOSE MONTHLY DEPOSITS ARE MORE THAN $500 BUT LESS THAN $3000 MAKE THEIR DEPOSITS ONCE A MONTH, AND EMPLOYERS WHOSE MONTHLY DEPOSITS ARE MORE THAN $3000 MAKE THEIR DEPOSITS EIGHT TIMES A MONTH.

FOR A SMALL BUSINESS, THE DIFFERNCE BETWEEN THE TWO IS MAMMOTH. THE ACCELERATED EIGHT TIMES A MONTH SCHEDULE SUBSTANTIALLY INCREASES PAPERWORK

AND THE LIKELIHOOD OF CONFUSION, MISTAKES, AND UNNECESSARY CONFRONTATIONS WITH THE IRS.

THEREFORE, MY BILL WILL PROVIDE RELIEF FOR THESE VERY SMALL BUSINESSES BY INCREASING THE THRESHOLD FROM $3000 TO $5000--A LEVEL THAT GENERALLY INCLUDES BUSINESSES EMPLOYING 20 OR FEWER EMPLOYEES; THEREAFTER, THE THRESHOLD WOULD BE INDEXED IN ORDER TO REDUCE PAPERWORK BURDENS AND INCREASE CASH-FLOW.

REGULATORY FLEXIBILITY

TOO OFTEN REGULATORY AGENCIES DRAFT THEIR REGULATIONS WITH LARGE BUSINESSES INMIND AND WITHOUT CONSIDERING THE IMPACT ON SMALL BUSINESSES THAT HAVE FEWER RESOURCED TO KEEP INFORMED ABOUT COMPLICATED REGULATIONS.

THE REGULATORY FLEXIBILITY ACT OF 1980 HELPED ALLEVIATE THIS BURDEN BY REQUIRING AGENCIES TO PREPARE AN ANALYSIS OF THE IMPACT OF THEIR PROPOSED REGULATIONS WILL HAVE ON SMALL BUSINESSES AND DESCRIBES ALTERNATIVES THAT COULD MINIMIZE THE IMPACT.

UNFORTUNATELY, SOME AGENCIES HAVE EXEMPTED THEMSELVES. THE IRS HAS STATED THAT THE ACT DOES NOT APPLY TO INTERPRETIVE REGULATIONS. AS A PRACTICAL MATTER, THIS AMOUNTS TO A BLANKET EXEMPTION FOR MANY IMPORTANT IRS REGULATIONS THAT HAVE MAJOR IMPACTS ON SMALL BUSINESSES.

AN EXAMPLE OF THIS IS THE IRS REGULATION FOR AUTOMOBILE RECORDKEEPING REQIUREMENTS OF THE 1984 TAX BILL WHICH WOULD HAVE PROVEN A TREMENDOUS BURDEN ON SMALL BUSINESSES. YET, THE IRS ASSERTED THAT THIS REGULATION WAS EXEMPT FROM THE REGULATORY FLEXIBILITY ACT.

IN ORDER TO BRING IRS INTO THE MAINSTREAM AND REQUIRE THEM TO PERFORM REGULATORY FLEXIBILITY ANALYSIS ON NEW REGULATIONS, MY BILL WILL EXPLICITLY APPLY THE RFA TO ALL IRS RULES AND REGULATIONS, INCLUDING INTERPRETIVE ONES.

CAPITAL EXPENSING

UNDER CURRENT LAW, TAXPAYERS RECEIVE A 10% INVESTMENT TAX CREDIT WHEN PURCHASING MOST EQUIPMENT AND CAN FURTHER DEDUCT THE COST OF THAT

EQUIPMENT'S DEPRECIATION ON AN ACCELERATED BASIS. TO MAKE THESE CAPITAL COST RECOVERY PROVISIONS SIMPLER FOR FARMERS, RANCHERS, AND SMALL BUSINESSES, TAXPAYERS CAN ELECT TO DEDUCT UP TO $5,000 IN CAPITAL COSTS IMMEDIATELY RATHER THAN USING THE ITC/DEPRECIATION SYSTEM.

THE HOUSE TAX REFORM BILL REPEALS THE ITC AND LENGTHENS THE DEPRECIATION PERIOD FOR MOST EQUIPMENT BECAUSE THE EXEMPTIONS FAVOR THOSE WITH CONSIDERABLE AMOUNTS OF ECONOMIC INCOME WHO PAY LITTLE OR NO TAX WHILE OTHERS WITH LESSER INCOMES ARE LEFT FULLY EXPOSED TO HIGH TAX RATES.

THE HOUSE TRIES TO COMPENSATE FOR THE EFFECT OF THE REPEAL OF ITC ON FARMERS, RANCHERS AND OTHER SMALL BUSINESSES WHO MUST MAKE SUBSTANTIAL EQUIPMENT PURCHASES IN ORDER TO MODERNIZE BY INCREASING THE IMMEDIATELY DEDUCTABLE CAPITAL COSTS FROM $5000 TO $10,000. HOWEVER, THIS DOES NOT ADEQUATELY OFFSET THE EFFECT.

CONSEQUENTLY, I ALSO PROPOSE TO INCREASE THE AMOUNT OF IMMEDIATELY DEDUCTIBLE CAPITAL COSTS FROM $5000 TO $25,000.

MEDICAL INSURANCE DEDUCTION FOR SELF EMPLOYED

UNDER CURRENT LAW, WHEN EMPLOYERS PROVIDE EMPLOYEES WITH MEDICAL INSURANCE, THE EMPLOYEE CAN EXCLUDE THE COST OF THAT INSURANCE FROM THEIR GROSS INCOME.

SELF EMPLOYED SMALL BUSINESS PEOPLE, FARMERS, AND RANCHERS WHO PURCHASE THEIR OWN INSURANCE, HOWEVER, CANNOT DEDUCT IT. AS THE AMERICAN FARM BUREAU POINTS OUT, "THE INEQUITY THAT EXISTS FOR SELF-EMPLOYED FARMERS WHO ARE PAYING SEVERAL THOUSAND DOLLARS PER YEAR FOR HEALTH INSURANCE ADDS SIGNIFICANTLY TO OUR COST OF DOING BUSINESS."

TO CONFORM THE TREATMENT OF SELF-EMPLOYED BUSINESSPEOPLE TO THAT OF TAXPAYERS RECEIVING EMPLOYER-PROVIDED HEALTH INSURANCE, I PROPOSE TO PERMIT SELF-EMPLOYED TAXPAYERS TO DEDUCT ONE-HALF THE COST OF THEIR HEALTH INSURANCE PREMIUMS AS A BUSINESS EXPENSE.

CONCLUSION

MR. CHAIRMAN, THESE PROVISIONS WILL HAVE A MINIMUM OF FISCAL IMPACT ON THE FEDERAL BUDGET WHILE UNBURDENING SMALL BUSINESSES FROM GOVERNMENT PAPERWORK, EXPENSE, AND UNFAIR TREATMENT.

I BELIEVE THESE PROVISIONS WILL "MAKE A DIFFERENCE" FOR SMALL BUSINESSES WITHOUT MAJOR ADJUSTMENTS AND INCREASED COST--IN FACT, IT SHOULD HAVE THE OPPOSITE EFFECT.

I THANK THE CHAIRMAN FOR AN OPPORTUNITY TO ADDRESS THE COMMITTEE ON THESE PROVISIONS AND WILL WELCOME ANY COMMENT FROM OUR WITNESSES HERE TODAY.

The **CHAIRMAN**. Senator Nickles.

Senator **NICKLES**. Mr. Chairman, let me thank you for this hearing and also a hearing that we will be holding in Oklahoma next Monday.

I apologize to our witnesses. I missed your statements. Let me ask you, Mr. Fairbanks, were you in opposition to the House-passed bill?

Mr. **FAIRBANKS**. My response was that, if the Senate passed the bill as it came out of the House, our organization would be opposed because of its effect on savings and investment. We favored the House passing the bill in order for the Senate to work on it and hopefully correct some of the problems in it.

Senator **NICKLES**. Mr. Schneier, what about NFIB?

Mr. **SCHNEIER**. We would support H.R. 3838 over current law. We believe that there are some additional changes which could be made to this bill to make it better for small business, but we support the process moving forward.

Senator **NICKLES**. What about the merchants, Mr. Vail?

Mr. **VAIL**. We support H.R. 3838 as an improvement over existing law. We again feel that there could be some improvement, but basically we would support it.

Senator **NICKLES**. So you just kind of weigh the pluses and the minuses and come to that?

Mr. Fairbanks, I heard you say you represent what, a small manufacturing company?

Mr. **FAIRBANKS**. I am president of a small manufacturing company, Horix Manufacturing, which makes packaging machinery. I'm representing Small Business United, which is a group of small businesses in regional associations around the country.

Senator NICKLES. A quick question on the ITC's. I also was a small manufacturer before coming to the Senate. I, for one, have not been bothered by losing ITC's but have been very bothered by stretching out the depreciation time period. In other words, I'm not so sure that we needed the ITC's if you could actually shorten or bring out the time that you can expense; plus the fact on ITC's you get them if you are in a profitable situation and, unfortunately, I found out what it is like to work for a nonprofit organization as well. You don't get them when you're not profitable. There seems to me as though there are really some inequities that we don't need if we could, one, work and maybe make some improvements on the depreciation side. Would you agree with that?

Mr. FAIRBANKS. I think the combination of ITC and a reasonably rapid depreciation creates a balance between a choice of an investment that's going to be depreciated over a few years and an immediate expense in terms of the tax impact on it.

I would agree that the more rapid depreciation is the more critical area from our standpoint, and you are certainly right—the ITC is of no benefit to a company that is not making money.

Senator NICKLES. I also heard, I guess, some common concerns throughout the panel on, one, the pension provisions, whether it be 401(k) 10-year averaging, which was reduced to 5 years, and some of those other provisions dealing with pensions, penalties basically for early retirement, lump sums. The House is punitive on lump sum distributions. Would you agree with my assessment that that is one area that the Senate really needs to make substantial improvement in?

Mr. SCHNEIER. I suppose for NFIB our concern is not so great on the level of 401(k) provisions. We are concerned that over the last three or four years there have been tremendous changes made almost on an annual basis in the pension rules, and that that process as taken on a life of its own strictly for revenue purposes. Pension plans have been hurt. A lot of our members are saying that they are dropping their pension plans because of annual changes being required. So there is an additional problem in that respect.

Senator NICKLES. To our panel, again, I apologize.

Mr. Chairman, I thank you again for having the hearing.

I am going to review some of these statements prior to our Oklahoma hearing. I appreciate your input. Thank you very much.

The CHAIRMAN. Gentlemen, thank you very much.

Our next panel consists of Mr. James McCarthy, representing the National Small Business Association; Mr. W. Scott Smith, Jr., representing the National Association of Wholesaler Distributors; and Mr. John Satagaj, representing the Small Business Legislative Council.

Why don't we proceed? Mr. McCarthy, you go right ahead, followed by Mr. Smith, and, John, you'll be the cleanup hitter.

STATEMENT OF JAMES D. McCARTHY, EXECUTIVE VICE PRESIDENT, GENERAL BUSINESS SERVICES, ROCKVILLE, MD; REPRESENTING THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. McCarthy. Good morning. I'm Jim McCarthy. I'm here to represent the National Small Business Association which represents thousands of small business persons across the United States. I work for a firm called General Business Services, which is one of their members. GBS, my firm, functions through a network of about a thousand franchised business counselors who service small businesses, giving them tax and recordkeeping assistance.

The term "small business" is misleading. My firm, General Business Services, has about 300 employees and we're a small business. The firms we represent probably average seven employees or less and are very, very small businesses, and they have different needs than we at GBS do. These very, very small businesses make up about 70 percent of the total number of businesses and need our special attention.

The testimony that I have submitted focuses on six areas of small business needs that we think deserve special attention.

The first area involves accounting rules. The existing accounting rules require that any business, if it has inventory, no matter how insignificant, use the accrual method of accounting. The first Treasury bill would essentially require all businesses to use accrual accounting. The House bill has changed that, and, in essence, allows the business community to maintain the status quo.

There is, however, a very important point that is being missed. In the 1984 Tax Act the penalties concerning the use of an improper accounting method were dramatically strengthened. In the past many small businesses with small inventories used the cash method although technically they should have been on accrual and IRS enforcement was not very strict. Now tax return preparers and others are forcing small businesses to adopt an accrual method. It is putting a very, very significant burden on small businesses.

Take, for example, one client that we have. First he was laid off from his job, then he and his wife opened up a ceramics business which had previously been a hobby. They did about $40,000 in gross the first year, went almost to $80,000 the second year, and will probably gross over $100,000 in their third year. They can now just barely make a living if they report on a cash method, but if they go on an accrual method and have to pay taxes on significant paper receipts, they are really in tough shape.

What we are proposing is not just maintaining the status quo, but a change in the law that would allow very small businesses to use the cash method per se if their receipts were, say, $500,000 or less per year. Even if they have small inventories, this would be a significant way to help small embryo businesses to get started.

Back in 1981, when ACRS was being promoted, the small business community was urged to support it on the grounds that ACRS would make recordkeeping easier for small businesses, which it didn't. The investment tax credit with respect to very, very small businesses however does the job that it is supposed to do.

Take my ceramics client, for example. In their first year the investment credit held their tax liability down but also actually gave them a small influx of capital because they had excess investment credit they carried back and generated an IRS refund. After they become profitable, the first thing we are going to suggest is that they modernize—buy a new furnace, a new kiln, and so on, thus minimizing their tax liability. The investment credit does the job that it is supposed to do in encouraging investment in new equipment with respect to the very, very small businesspersons.

The first Treasury bill didn't have graduated rates. Broadening the tax base and yet using a 35-percent tax rate, would dramatically increase the tax burden of small corporations. The House bill provides a graduated tax rate, but it isn't graduated enough. We need further study. We appreciate the work that has been done by Senators Bumpers and Sasser in this area, but we need some real study to come up with better brackets that will truly make the graduated tax rate revenue neutral for small as well as larger businesses.

Retirement plans—President Reagan's State of Small Business speech indicated that only 14 percent of businesses with 1 to 24 employees had retirement plans, whereas 72 percent of businesses with over 500 employees had retirement plans. A lot of this is due to complexity. The changes that have taken place over the last couple of years are discouraging small businesses from adopting retirement plans for their employees.

Last year the IRS came out with a change in reporting which required many small businesses to start filing form 5500's again. These forms hadn't been required for a number of years. The results were disastrous. The IRS had to extend the filing date several times, and the information necessary to comply just wasn't available from many insurance companies and so on. The information that the IRS finally received was very inaccurate.

The idea is that we want to keep retirement plans available which are important for small business persons, but the rules should be kept simpler.

Participation in fringe benefit programs, especially in the health and welfare areas are losing small business participation because of the complexity of the rules. Taxing employees on a part of the contribution made on the part of the employer certainly wouldn't help.

One final comment that is not included in my written testimony. The House bill takes over 1,000 pages to describe. Many of the provisions are carryovers from the Treasury bill. Better than half of these provisions are provisions that were suggested by the IRS and the Treasury, the policemen, to make their job easier. They call them house-cleaning changes, but there are many areas that the Congress won't have time to look at carefully.

A good example in the prior tax bill was the auto log thing that we all exploded so violently over, because it affected so many people. There are many other provisions that, when so many things are thrown at us, don't get as thorough review that they should. I would hope that if the Senate sits down and starts over and comes up with a real good reform bill, they won't throw in a lot of these Treasury house-cleaning changes at this point, but will put them off for a couple of years and let us consider them more thoroughly in the future.

Thank you for giving me a chance to testify.

[The prepared statement of Mr. McCarthy follows:]

STATEMENT OF
JAMES D. McCARTHY
ON BEHALF OF THE
NATIONAL SMALL BUSINESS ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON SMALL BUSINESS
HOLDING HEARINGS ON
THE IMPACT OF TAX REFORM AND SIMPLIFICATION ON SMALL BUSINESS
FEBRUARY 6, 1986

Mr. Chairman and Members of the Committee:

My name is James D. McCarthy. I am Vice President of General Business Services of Rockville, Maryland. GBS has about 1,000 franchised business counselors nationwide who serve small businesses exclusively. Two areas of special concern are recordkeeping and tax matters.

Today I am here on behalf of the National Small Business Association (NSB), a multi-industry trade association representing approximately 40,000 small business firms nationwide.

You, as members of this Committee, share my concerns as to the impact of tax reform and simplification on small business. We must continuously keep the general public aware of the plight of the hundreds of thousands of small businesses in this country.

A great many of the tax proposals being considered and discussed are aimed at improving the inequity of the present system and to close what some perceive as loopholes. While we wholeheartedly agree with these aims, we would hope that any changes not cause undue burdens on small business.

This segment of our business world is a fragile area of our economy. Thousands of businesses come into existence each year and thousands cease operations. The causes of cessation are many. But it is a cruel fate to put an embryo company out of business due to the tremendous burdens of record-keeping and restrictions imposed by inequitable tax laws. These businesses need nurturing, just as a baby needs nurturing by its parents. Without the TLC of our tax laws, a new business may be forced out of existence. And who can say that this business would not be another "giant" in our economy in a few years, adding jobs and capital investment.

The areas we are particularly concerned with are:

1. Accounting methods
2. Investment tax credit
3. Graduated rates
4. Retirement plans
5. Fringe benefits

Accounting Methods

The tax bill as passed by the House of Representatives and the tax proposals presented by the President both contain provisions which would require that all businesses use an accrual method of accounting if it is used for management and/or financial purposes. Accrual accounting would be required even if the business had no inventory which would otherwise require the use of this method.

In the accrual method, as you are all aware, income must be recognized when earned even though the cash has not yet been received. Taxes must be paid on this income. From my experience, small businesses are more likely to have a larger proportion of their accounts go bad than are big businesses. The company with the worthless receivable has a bad debt. However, this may happen a year after the income has been reported and the taxes have been paid on that amount.

As an example, assume that a small company has reported $3,000 income for which it has not yet received the money. At the lowest tax bracket, the corporation will have to pay $450 in taxes. (If the business is a sole proprietorship, the amount of taxes paid is even higher due to the imposition of increasing self-employment taxes as well as income taxes.) Although the $450 may not seem like a lot to some, it can be of great significance in a small business where cash is always scarce. To continue our example, the company learns the following year that this receivable is not to be paid. The company can take a deduction for the $3,000 and will save $450 in taxes. But the present value of that tax savings has caused that $450 to be worth perhaps only about $400. In effect, the company has given the federal government an interest-free loan.

With the strict requirements and severe penalties now in the law regarding methods of accounting, General Business Services has been preparing many requests for changes in accounting methods. Even though the adjustments amount to a few thousand dollars, the inclusion of these adjustments into the income of the business is causing a great deal of hardship in many cases. The results are numerous: in most instances, the bullet is bitten but some companies have to incur further indebtedness to pay the additional taxes, putting a further strain on their finances. In a few instances, a company may decide to ignore the requirement to change and play "audit roulette" - a risk that we cannot condone. However, their reasoning is that the only alternative is to go out of business because of the increased tax burden over the next few years.

Since cash flow has always been a major problem of small business, we suggest that all small businesses with gross receipts under a specific threshold - perhaps $500,000 - be allowed to use the cash method of accounting, whether or not they have inventory. Once the gross receipts threshold has been reached, the required adjustments should then be recognized over a period of years. This type of exemption is not without precedence. Now, all farmers are permitted to use the cash method of accounting, no matter what their gross receipts and no matter whether they have inventory.

Investment Tax Credit

There has been much written about the inequities of the Investment Tax Credit. However, from our personal experience, it is one of the few provisions of the present Tax Code which is a real boon to small business. We suggest that it be retained in, perhaps, a modified form.

Many small companies purchase equipment that they otherwise might not be able to do without the incentive of the investment tax credit. This additional equipment helps the business expand and to become a viable taxpaying entity in the future. Our economy also benefits because of the increased capital expenditures. The House bill broadens the tax base at least as much, and possibly more, for small firms. Recent studies by the SBA show that small businesses tend to be somewhat more capital intensive than larger, more established firms in the same industries. Not only in manufacturing, but surprisingly in services. When you think of trucks, busses, computers, and other specialized equipment needed to render these services, you can appreciate this set back for many service segments of the economy, where the rapid growth is taking place and where new and small business tends to predominate.

Graduated Rates

The House bill would actually roll back the benefits of graduation that this Committee fought for and achieved in 1975, 1976, and 1978. Because graduation would actually be tighter, the large corporations and the high growth corporations will receive the lion's share of the rate reductions. A company earning $25,000 gets no rate reduction at all. A company with $50,000 in taxable income would receive a rate reduction of $750. A company earning $75,000 would get a $2,000 reduction, but above that figure, the company would have to start paying the same full corporate rate that the largest companies in the country would pay, and would also begin paying back the benefits of the reduced rates in the lower brackets.

By our rough calculations, the 10% of the corporations earning more than $100,000 will have their taxes cut by about $85 billion over five years, while the 90% of corporations earning less than $100,000 annually would receive about $2 billion in rate cuts. We do not believe that this kind of distribution makes sense for jobs, innovation, and economic growth. In 1981, the Ways and Means Committee reported a proposal to graduate the rates up to $200,000, which would at least allow a little latitude for growth. The Committee also cut the revenue costs of its measure by phasing in the reduction of the top rate. If this were done with the current bill, it might pay for increased graduation, and then some. We would hope that the Senators on this Committee might take the lead in requesting the necessary revenue estimates and doing the technical work so that such a proposal can be considered by the Finance Committee and the full Senate. We appreciate the work done in the tax area in the past by the Chairman of this Committee (as to S. Con. Res. 41) and by the Senators from Arkansas (Sen. Bumpers) and from Tennessee (Sen. Sasser).

Retirement Plans

Congress has been making ever more frequent changes in the rules relating to pension and profit-sharing plans. The rules changed significantly in 1982 and again in 1984 and now we are faced with the possibility of yet another change in these rules. Long-range programs, aimed at providing retirement income security, operate much more efficiently under stable conditions and tend to be unattractive when conditions are changing rapidly. Whatever is done in the pension area, we would hope that if Congress sees fit to make more changes it will then let the coverages operate on their own for a while. Small business in particular needs some respite from the continual change that has characterized pension regulation recently.

We feel that a frequently discussed area relating to retirement benefits would be detrimental to small business. This concerns the top-heavy provisions which impose severe limits on retirement plans of small businesses. The President proposed eliminating certain confusing and complex rules for nontop-heavy plans, but at the same time proposed changes in the benefits structure for top-heavy plans.

These top-heavy rules do not apply to most major employers, but they impose a fearful burden on small business. To eliminate these sources of complexity only for nontop-heavy plans would promote the adoption of tax-favored plans only by big business. At the same time, small business would be apparently left with the onerous top-heavy rules and would have a significant disincentive to establish retirement plans. We believe this inequity should be eliminated for both large and small employers.

Our company, GBS, has found that many small corporations and sole proprietorships which have qualified plans have become fed up with the labyrinth of rules now in effect and many plans are being terminated. In addition, many employers are unwilling to adopt qualified plans because of the nearly overwhelming complexities involved. Thus, a large segment of the working public is without any retirement plan. These workers will be relying entirely on benefits from Social Security and whatever they are able to put aside themselves. Hopefully many are using IRAs to accumulate retirement savings. But we both know that not all employees are taking advantage of these.

This seems to be corroborated by the report of President Reagan on "The State of Small Business," transmitted to the Congress in May of 1985. The report shows that in 1983 only 14% of workers in firms employing 1 to 24 persons were covered by a pension plan. This compares with 72% coverage in firms with 500 or more employees. Furthermore, the pension coverage is not being expanded since the ratio four years earlier was 15 percent. The reasons are fairly clear. The rules and requirements for establishing and maintaining a qualified pension plan are extremely complex, and the most complex rules, such as the multiple plan limits and top-heavy plan rules, fall the heaviest on small business.

A hopeful trend we have seen is that some of these employers who are terminating their retirement plans are using the provisions of Simplified Employee Plans (SEP). This allows the employer to contribute to an employee's retirement savings, and has the advantage of avoiding all the reporting requirements now demanded for qualified retirement plans. The interesting aspect of this trend towards SEPs is that the employer is making the contributions even though the employee is 100% vested in the contributions from the very beginning, rather than a sliding scale vesting allowed for qualified plans. Also, the thresholds for qualifying employees is much less for SEPs than for qualified plans. In other words, the employer is avoiding the reporting and complexity of qualified plans at the expense of covering more employees and perhaps making larger contributions on their behalf. Maybe there is a lesson to be learned here. Take away the complexity for small business and there will undoubtedly be greater participation.

Fringe Benefits

The proposals on health and welfare plans would also affect small business. The "State of Small Business" indicates that approximately 39 percent of wage and salary workers in firms employing 1 to 24 individuals are covered by health insurance, as compared with 85 percent of the workers in firms with 500 or more. One reason for the discrepancy in coverage now probably relates to the inability of small firms to pay the heavy costs involved in the generous health plans that are considered the standard. In the future, however, if the proposed nondiscrimination rules are enacted, the increased discrepancy may be due to the intolerable burden placed on small business.

The various proposals consider taxing the employee on coverage over a certain amount. This could be dangerous. Since it would initially cost each employee relatively little, it has superficial appeal. But experience shows that once a mechanism like this is in place, the price can go up and up. The result will be less comprehensive protection for those who now have it, and less chance of securing protection for those who don't have it but want it. Congress has successfully, over many decades, encouraged the private sector to construct a broad effective system of employee benefits. To change directions now, at a time when government programs for medical care are being squeezed, would be very wrong. Although the government can cause the scope of group health insurance protection to shrink, the need for that protection will not change.

The chief problem with the proposed changes to health and welfare coverages, including group life insurance, will be related to the new and complicated nondiscrimination rules that would apply. These rules would impose far stricter limits on small business than on big business, since the prohibited group would include one percent owners, the highest compensated ten percent and any of their family members. Because small firms employ family members, at the outset then, the prohibited group is likely to be far bigger than the nonprohibited group. Thus, the small firms, which can cope with compexity the least, will be primarily the ones subjected to the convoluted rules.

By and large, the proposals for nondiscrimination may well appear reasonable in theory. In practice, we can foresee, however, a considerable degree of difficulty on the part of small business in maintaining the records necessary to make and meet these tests. Indeed, we see the tests being designed in such a way that the smaller the business, the more difficult it is to meet the test. We deplore standards of this sort that fall most heavily on the smallest businesses.

If Congress is really concerned about discrimination, the simplest thing to do would be to require that all full-time employees be covered by any plan. Let the nondiscrimination rules apply to plans where all employees are not covered.

Thank you for the opportunity to express our views.

# # #

The **Chairman**. Senator Kasten.

Senator **Kasten**. Mr. Chairman, thank you. I've got to go back down to another committee meeting. I just want to say that the same people who brought us automobile reporting requirements, that brought us 10 percent withholding and instant dividends, that brought us this whole wish list of attributed interest on loans within families and among partners and corporations—that same group of people, somehow there is a group of gremlins tucked in there in the lower levels of the Treasury; they don't change when the administration changes; they don't change when the House or the Senate changes or when the committee chairmen change, and they just go on their way down there and every once in a while they win a few.

Unfortunately, this last tax bill that came out of the House of Representatives, I think they won many more than usual. Then we sit there and beat them back. It affects small business more than large business because small business has to sit there and work their way through those forms themselves, and you look at turning inside out the 401(k)'s are turning inside out all of these different retirement programs, and we're just hurting ourselves.

Mr. Chairman, I wish I could be hear for more of this hearing, but I might try to get back. I thank Mr. McCarthy very much for his statement.

The **Chairman**. Thank you very much, Senator Kasten.

Mr. Smith.

STATEMENT OF W. SCOTT SMITH, JR., PRESIDENT, STULL ENTERPRISES, CHADDS FORD, PA; REPRESENTING THE NATIONAL ASSOCIATION OF WHOLESALER DISTRIBUTORS

Mr. **Smith**. Mr. Chairman, members of the committee, I'm president of Stull Enterprises in Chadds Ford, PA, a distributor of outdoor power equipment—lawnmowers and the like. I'm also the immediate past chairman of the National Association of Wholesaler Distributors, and it is on behalf of NAW's 45,000 member companies that I appear today.

Mr. Chairman, we thank you and the committee for the opportunity to offer our views on the President's tax reform proposal and H.R. 3838.

NAW is a founding member of the Tax Reform Action Coalition. TRAC was specifically formed to support reform of the Tax Code consistent with the principles underlying the President's May 24 proposal; namely, to achieve greater fairness and neutrality in taxation by substantially reducing marginal tax rates.

NAW strongly supported both the President's proposal and H.R. 3838 as passed by the House last December. Mr. Chairman, our written testimony details the reasons for our support and the impact of these two proposals on our industry, which pays one of the highest effective tax rates in the country, according to the Joint Committee on Taxation.

Given the time constraints, I would like simply to highlight a few points from our testimony.

The wide disparities in effective tax rate under the current code are extremely unfair. While some taxpayers can reduce their obligations through credits and deductions, others cannot even though they have the same operating income. Most small businesses fall into the "cannot" category.

As a result, the core of the President's proposal and H.R. 3838 for wholesale distributors is the dramatic reduction in the top corporate tax rate combined with more favorable graduated rates for smaller businesses. Both proposals contain graduated rates that are more favorable than current law with the rates in the House bill being particularly favorable.

This rate structure provides across-the-board benefits which cannot be duplicated by tax preferences. In my own company's case, the reduction in our maximum tax rate from 46 to 33 percent proposed by the President would mean more of my company's earnings would be retained and used for investment in plant equipment and inventory.

This benefit, significantly increased pretax earnings, would be multiplied throughout the wholesale distribution industry and retained earnings represent wholesale distributors' overwhelming source of growth capital.

However, the House bill begins to recapture the benefits of graduated rates at $100,000 in earnings. The President does so at $140,000. These points are set artificially low. Recapture should be eliminated or the point at which it begins raised substantially.

Another favorable aspect of H.R. 3838 is that it provides a simplified last-in, first-out or LIFO method of inventory accounting for companies with $5 million or less in gross receipts. The LIFO provision addresses the long-term small business need as documented by an FTC study and past work by this committee.

Simplified LIFO will allow smaller companies to retain more earnings, thereby increasing their investment capability. However, it is essential that the $5 million cap be eliminated or substantially raised since many small businesses exceed $5 million in gross receipts. This committee can and should be instrumental in making that case to the Senate.

In terms of capital cost recovery, NAW believes that the capital cost recovery provisions should be improved even though we do not agree with those who claim that the President's proposal and H.R. 3838 would devastate business. Nonetheless, we urge that capital assets, including structures, be indexed to inflation, as proposed by the President.

Also, H.R. 3838's increase in expensing limit for small businesses is both very necessary and very favorable and a further increase is recommended.

Moreover, the troublesome limitations on new savings generated mechanisms such as 401(k) plans should also be addressed. Such saving plans are important vehicles for generating capital in our economy, important for our economy, and should be encouraged to the greatest practical degree. We need to encourage savings today to provide more capital to enhance our free enterprise system.

Finally, this committee must forcefully assert itself on behalf of the liquidation distribution provisions in H.R. 3838. Specifically, these provisions contain an essential exemption for closely held corporations which permits the transfer of business without penalty.

In summary, NAW supports rate reduction rather than preference allocation. Indeed, any changes in H.R. 3838 should not be paid for by higher rates. Lower rates will enable capital to be allocated in our economy in accordance with market forces rather than tax policy considerations. This can only benefit the small business sector immensely.

As I've noted, NAW would strongly support either the President's proposal or H.R. 3838 over current law. Many other businesses, large and small, would do the same. I brought with me a chart listing some of these businesses that are involved in our TRAC organization.

[Mr. Smith holds up large chart.]

Mr. SMITH. I've taken the liberty of having these charts delivered to your offices in smaller form and to become part of the record, to help dispel the myth that business doesn't support tax reform.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Smith follows:]

STATEMENT OF

W. SCOTT SMITH, JR.
PAST CHAIRMAN OF THE BOARD
NATIONAL ASSOCIATION OF
WHOLESALER-DISTRBUTORS

BEFORE

UNITED STATES SENATE
COMMITTEE ON SMALL BUSINESS

ON

TAX REFORM: THE IMPACT OF THE
PRESIDENT'S PROPOSAL AND H.R.3838

I. INTRODUCTION

My name is W. Scott Smith, Jr. I am President of Stull Enterprises, Chadds Ford, Pennsylvania, a distributor of outdoor power equipment. My company employs a total of 75 people in our home office and in our branches in Pittsburgh, Pennsylvania, and Beltsville, Maryland.

I am also the immediate Past Chairman of the National Association of Wholesaler-Distributors (NAW) and it is in that capacity that I appear today.

I want to point out at the outset that NAW is a founding member of both the Coalition to Reduce High Effective Tax Rates, and the Tax Reform Action Coalition or TRAC, which was formed for the specific purpose of supporting efforts to reform the tax code consistent with the principles underlying the President's May 28, 1985, proposal; namely to achieve greater fairness and neutrality in taxation by substantially reducing marginal tax rates.

I also want to commend you, Mr. Chairman, and this entire Committee for beginning your own examination of the impact of the President's tax reform proposal and H.R. 3838 on smaller businesses early in the Senate process. As that process moves forward, NAW hopes that the Senate will focus on the reasons which led the President and the American public to the consensus that reform of the tax code is needed: the current system is unfair, unnecessarily burdensome and, on the corporate side, discriminatory between various economic activities.

NAW would also like to commend the House Ways and Means Committee for the record. The Ways and Means Committee did an extraordinary job of producing a bill under tremendous political pressure and the attempt to reform our tax system would have died but for that effort.

In NAW's view, the question is not whether the system needs to be changed. It is simply a question of how the system should be changed.

In that regard, the National Association of Wholesaler-Distributors strongly supported both the President's May 28 tax reform proposal and H.R.3838, the Tax Reform Act of 1985, as substantial improvements over current tax law and policy.

In our view, both the President's proposal as advanced last May* and H.R. 3838 provide the foundation for sound, sustained economic expansion by bringing more fairness, efficiency, and neutrality of impact to our tax system for both individuals and businesses.

The current tax situation relative to the wholesale distribution industry helps to tell the story why.

II. THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS AND THE WHOLESALE DISTRIBUTION INDUSTRY

The National Association of Wholesaler-Distributors is a federation of 120 national wholesale distribution trade associations (a list is attached as Appendix A), 60 state and regional trade associations, and over 7,000 individual wholesale distribution firms. All told, NAW represents approximately 45,000 wholesale distribution companies with 150,000 places of business nationwide.

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* NAW's support for the President's proposal lessened considerably after it was modified in August, 1985, by eliminating the proposal to index first-in, first-out inventories to inflation.

The wholesale distribution industry is not always immediately visible to the naked eye. It is, nonetheless, a massive and rapidly growing part of the American economy.

NAW's membership, which is dominated by smaller businesses, is responsible for over 60 percent of the $1.4 trillion of merchandise which flows through wholesale channels annually. NAW members also employ a comparable percentage, or 3 million, of the over 5 million Americans who work in the wholesale trade. Thus, while the individual firms which our organization represents are small individually, their collective economic importance is extremely significant.

The Joint Committee on Taxation's annual study on effective tax rates consistently shows that the wholesale distribution industry pays either the highest, or the second highest, effective tax rate of the industries studied -- approximately 35 percent in 1983 and 36 percent in 1982.

III. LEGISLATION LIKE THE PRESIDENT'S PROPOSAL OR H.R. 3838 IS NEEDED

A. Problems in the Current System

The current tax system is grossly unfair. The need for comprehensive change in our income tax laws has built steadily for a number of years because of this. The numerous deductions, exclusions, and credits which complicate the code have been used as tools to influence "economic" decisions. However, the ad-hoc approach by which these provisions have been implemented over time has resulted in an uneven and illogical distribution of "benefits".

Consequently, very wide disparities have been created in the effective tax rates paid by various industries, by various economic sectors, and even by companies within those sectors. For wholesaler-distributors, these wide disparities in effective tax rates are the most fundamental manifestation of the unfairness of the current code.

Some taxpayers can reduce their tax obligations through tax credits and deductions while a similar opportunity is denied to other taxpayers with comparable taxable income simply because they are in a business where the activities needed to trigger these credits are of secondary importance, at best, to their direct business operations.

For instance, labor and inventory-intensive industries, like wholesale distribution, make relatively nominal use of most of the capital cost recovery provisions in the tax code which enable other industries and companies with similar net taxable income to pay much lower rates of tax. The reason is that 80 percent of the typical wholesaler-distributor's assets are in inventory and accounts receivable, not in capital assets.

The result is a tax subsidy for certain types of business activity and investment at the expense of the high effective rates paid by others. Absent compelling justification, the National Association of Wholesaler-Distributors believes that the tax laws should not so favor one type of business over another.

As previously noted, the Joint Committee on Taxation's effective tax rate studies document that our industry, among others, pays an extremely high effective rate. This unfairly places the smaller businesses which comprise NAW's membership at a competitive disadvantage vis-a-vis others with tax code-created low effective rates.

I would note, however, that we do not seek to cast blame on corporations or economic sectors that pay little or no federal taxes; they are merely exercising good business sense in following the social and economic directives legislated into the tax code for the purpose of minimizing their tax liability. Rather, our point is that all industries and economic sectors, for example, wholesale distribution, retailing, and manufacturing, are vital to the well-being of the American economy. In our judgement, no compelling justification which withstands objective analysis has yet been advanced during the tax reform process for treating similarly profitable companies differently for tax purposes. And, we suspect that in objective terms none will emerge.

B. The Need for Neutrality

Given the current disparities in effective tax rates, it is clear that a fundamental goal of tax restructuring must be neutrality. You may not be able to make the tax system entirely neutral, but it should be as economically neutral as possible between similarly-situated taxpayers.

While the wholesale distribution industry enjoys relatively few tax benefits, the industry has grown rapidly over the last eight years. Industry sales have more than doubled from $676 billion to $1.4 trillion since 1977. At the same time, the industry has increasingly provided better and more extensive services to both manufacturers and to its customers to help in the distribution and effective marketing of their products.

If we were able to keep more of our earnings to plow back into our businesses rather than pay them to the Federal government, the growth in the wholesale distribution industry would be even more dramatic. Hence, Mr. Chairman, wholesaler-distributors view broadening the tax base by eliminating many of the current preferences in the tax code in return for rate reduction as a necessity. No doubt this will hurt some. Indeed, there are a number of base-broadening provisions in the President's proposal and H.R. 3838 which, in and of themselves, will negatively impact wholesaler-distributors. However, the significant reduction in corporate tax rates in those proposals outweighs these factors to the benefit of both our industry and the economy as a whole.

Central to this conclusion is our belief that market forces, rather than public policy, no matter how skillfully crafted, can best determine investment decisions. Of identical import is that retained earnings are the principal and often sole source of seed capital for the small, entrepreneurial businesses which dominate our industry and which are represented by this Committee. America's economic resurgence has been driven by entrepreneurs creating jobs. Yet, the growth of such businesses is simultaneously thwarted by high effective rates generated by current tax policy.

Both the President's May 28, 1985 proposal and H.R. 3838 as passed by the House, while not perfect, would be sustantially better than current law as an examination of a few of their major provisions demonstrates.

IV. LOWER CORPORATE TAX RATES

For wholesaler-distributors, the core of both proposals under consideration here is the reduction in the top corporate tax rate from 46 percent to 33 and 36 percent respectively, combined with the retention of graduated rates on annual earnings of $75,000 and below.

The reduction of the top corporate tax rate to no higher than the 33 to 36 percent in the proposals must be retained as the central feature of any tax reform package. If trade-offs are to be made, they should not be made at the expense of lower rates. Trading preferences for rate increases entirely undermines the rationale for reforming the tax laws.

A. The Benefits of Lower Rates

Major long-term benefits for the general economy will be derived from substantial tax rate reductions. As noted by 13 of America's most distinguished economists (see Appendix B) in their letter to the House Ways and Means Committee last November, "the most powerful and efficient incentives are market forces, not tax provisions. By far the most productive 'tax incentive' would be to have the lowest possible rates."

The overall long-term economic benefit of substantial tax rate reductions will be a parallel reduction in the impact which the heavy hand of high rates has on the millions of business and personal financial decisions which are made each day. The rate of tax which a person expects will be imposed on the income from making additional investments or from providing more hours of personal labor certainly affects his or her willingness to do that which is otherwise economically sound.

This effect may be so direct and strong as to lead the individual or the business manager to forego doing something because the benefit no longer outweighs the combination of time, resources and taxes which it will cost. Or, more likely, the taxpayer seeks to lessen the tax bite on work and investments by taking actions which do not make sense otherwise. "Tax shelters" for individuals and lease financing subsidaries for many corporations are examples of perfectly rational responses to high tax rates on individuals and corporations.

Moreover, a substantial reduction in marginal corporate tax rates produces across-the-board benefits which cannot be duplicated by tax preferences. Lower rates would mean a significantly smaller tax burden on each dollar earned by a corporation as profit on the business in which it engages.

In my own company's case, the reduction in our maximum tax rate from 46 percent to the 33 percent proposed in the President's package (36 percent or H.R. 3838) would mean more of my company's earnings would be retained and used for investment in jobs, inventory, warehouses, computers, delivery trucks, and services to both our suppliers and to our customers. The benefit of lower rates -- significantly increased retained earnings -- would be multiplied throughout the wholesale distribution industry.

B. Graduated Rates for Smaller Businesses

The same is true of the graduated rate structure. That rate structure is extremely important for the vast majority of wholesaler-distributors -- some 90 percent of our industry's members are small businesses.

The impact of graduated rates on smaller businesses can be shown by illustration. NAW opposed Treasury I, the Administration tax reform study released in November, 1984, because it lacked a graduated rate structure. In order to document the impact of that proposal's suggested flat corporate rate of 33 percent on smaller wholesaler-distributors, NAW commissioned a study by Arthur Andersen & Company in which Arthur Andersen ran the actual tax returns of smaller wholesaler-distributors against all components of the Treasury I package. The study, which is attached hereto as Appendix C, reveals that Treasury I's proposed 33 percent flat corporate tax rate would have meant an average 60 percent increase in tax liability for firms with less than $150,000 in taxable income. Over 90 percent of the retailers and wholesaler-distributors in this country earn less than that amount each year.

Graduated rates, then, are critical. In terms of the two proposals under consideration here, both the President's May 28th proposal and H.R. 3838 are better than current law for small corporations, and the House-passed H.R. 3838 is the better of the two. Combined with some other provisions outlined below, the House bill's rate structure -- 15 percent on $0 - $50,000, 25 percent on $50,000 - $75,000 and 36 percent above that -- allows smaller wholesaler-distributors and any other inventory or labor intensive business to retain more of its earnings. As previously noted, retained earnings are critical to wholesaler-distributors because they provide the "new" seed capital that is often unavailable or inaccessible to small firms from financial markets.

C. Graduated Rate Recapture

One noteworthy problem does exist with reference to the rate structure ... the point at which the benefits of graduated rates begin to be recaptured. Recapture begins at $140,000 in earnings under the President's proposal and at $100,000 in earnings under H.R. 3838. NAW believes either point is artifically low given the realities of the small business world today. Simply stated, with a too-low recapture point, the tax reform trade-off of lower rates for a broadened tax base becomes less compelling for many smaller businesses.

NAW believes that this Committee and the Senate as a whole should attempt to eliminate recapture or to move the recapture point higher.

V. INVENTORY ACCOUNTING

Another critical aspect of the President's proposal which NAW strongly endorsed was the indexation of FIFO, or First-in, First-Out inventories. As previously noted, the Administration's August, 1985 decision to drop "indexed FIFO" as part of its proposal substantially lessened NAW's support for the President's package since inventory accounting reform, like more favorable graduated corporate tax rates, provides necessary relief to the smaller members of our and other industries. Happily, however, as detailed below, H.R. 3838 provides inventory relief to smaller businesses.

The importance of inventory reform to small business lies in current law. An accurate measure of income from the sale of goods is dependent on the value of the goods on hand at the close of a taxable year for tax accounting purposes. Generally, the cost of goods sold during the year is equal to the dollar value of beginning inventory, plus purchases and other inventoriable costs incurred during the year, minus the dollar value of ending inventory. The measurement of income from the sale of goods varies with any change in ending inventory valuation. Hence, the cost of goods sold is lower if ending inventory has a higher value and gross income from sales is correspondingly higher. On the other hand, a lower figure for ending inventory increases the cost of goods sold and reduces gross income.

Inventories under current IRS regulations are generally valued at cost. While a taxpayer may identify each specific item of an inventory and ascertain its actual value to determine the cost of inventory, this actual identification method is impractical due to the quantity and nature of the goods and inventory on hand. As a result, the tax code and implementing regulations permit alternative methods which rely upon simplifying assumptions about the flow of goods from inventory.

FIFO is the traditional inventory accounting system. It defines the cost of an item taken from inventory as the original acquisition price of the oldest unit of this type of item in inventory; that is, it assumes that the first goods purchased or produced are the first goods sold. Under FIFO, the most recently purchased or produced goods are deemed on-hand at year end and ending inventories are valued at the most recent purchase or production cost. Hence, firms which base their decisions on FIFO costs will show higher accounting profits than they are actually making.

LIFO, or the last-in, first-out method, assumes that the last goods purchased or produced are the first goods sold. Since LIFO accounting values ending inventory at the oldest purchase or production cost, its use results in a higher cost of goods sold and lower taxable income than FIFO in periods of inflation.

Moreover, since the LIFO method treats the most recently acquired goods as the first goods sold, LIFO accounting reflects income from inventory sales more accurately during periods of inflation than the FIFO method does. While significant advantages accrue to firms using LIFO accounting in an inflationary economy, many businesses, particularly smaller businesses, continue to use the FIFO method due to the complexity and costs associated with LIFO.

That the FIFO method is widely used by smaller corporations despite LIFO's benefits is borne out by a Federal Trade Commission study. The study, Firm Size and Regulatory Costs: The Case of LIFO Regulations, Bureau of Economics Staff Report to the Federal Trade Commission (December, 1984), finds that:

> "Despite legalization of LIFO, many firms, particularly small firms, reportedly have not switched to LIFO. Reasons cited prominently by small firms for continuing to use FIFO include the costs of complying with LIFO regulations and uncertainties about the application of LIFO regulations."

Moreover, the FTC study concludes that:

> " . . . LIFO regulations have imposed compliance costs that are proportionately much larger for small firms than for large firms. This, in turn, has discouraged use of LIFO by such firms and put them at a competitive disadvantage during inflationary periods. The economy as a whole has been less efficient as a result of this regulation-induced bias against inventory intensive methods of doing business."

While the Administration decided to drop inventory accounting relief as part of its tax reform package, the House of Representatives included it in H.R. 3838. The House bill contains a simplified LIFO accounting provision designed specifically to help small business by addressing the problems noted above.

The provision, on which NAW worked closely with the Ways and Means Committee and the Joint Committee on Taxation, provides that companies with $5 million or less in gross receipts may elect to use a simplified dollar-value LIFO method in accounting for their inventories. The simplified dollar-value LIFO method requires that inventories simply be grouped into pools in accordance with the major categories of the "Producer Price Indexes" or the "CPI Detailed Report."

H.R. 3838's LIFO provision addresses a long-term small business need with the result that smaller companies will retain more of their earnings and increase their investment capability. However, the $5 million dollar gross receipts limitation on using simplified LIFO should, at a minimum, be increased. Like the graduated rate recapture point, it is artifically low. Many truly small businesses -- dependent upon type of business, the number of inventory turns in a given year, and other factors -- can easily and substantially exceed $5 million dollars in annual sales. They too need the relief of LIFO accounting and this Committee can and should be instrumental in making that case to the Senate.

VI. CAPITAL COST RECOVERY

NAW will limit its comments on capital cost recovery except to note the following.

The President's proposal indexed capital assets to inflation. Indexing capital assets to inflation substantially mitigated the stretch-out in the depreciation schedules (over current law) proposed by the President and, according to our calculations, made the proposal comparable relative to current law within five years. For that reason, NAW believed that it was economically sound and submits that the Senate should restore indexing or some modification thereof to the provisons of H.R. 3838.

With reference to H.R. 3838, we would note that its stretch-out in the depreciation schedules is mitigated by providing for greater acceleration (writing off more of an asset's cost) in the early years. Moreover, as it does with rates, inventories, and a number of other areas, H.R. 3838 singles out small business for necessarily different treatment by providing that smaller businesses may expense $10,000 of their investments in the first year as opposed to the $5,000 permitted under current law. Our analyses show that this increase in expensing is very favorable and we submit that a further increase in the expensing limit is appropriate and would have a beneficial impact on small business growth and investment.

We would also note that the cost recovery period for structures has been increased to 30 years with recovery limited to the straight-line method under H.R. 3838. Structures are the primary capital asset of wholesaler-distributors and many other small businesses. While we realize that structure depreciation has proven a fertile ground for abuse, we would submit that there must be a practical way to not penalize "working" structures because of a proliferation of "see-through" office buildings. Thus, absent indexing, certain structures should be subject to the same type of accelerated depreciation as other productive assets.

Both the President's proposal and H.R. 3838 contain troublesome limitations on new savings-generating mechanisms such as 401(k) plans. We support a more liberal approach to these new mechanisms to generating savings, and would urge the Senate to address this matter as it crafts its own bill. Such plans represent an important vehicle for generating capital in our economy, and take pressure off of the Social Security system to provide adequate retirement incomes.

As is obvious from the above, NAW believes that the Senate could well make improvements in the cost recovery area. However, NAW also believes very strongly that any such improvements should not be paid by increasing marginal rates.

VII. LIQUIDATING DISTRIBUTIONS

Finally, Mr. Chairman, the Small Business Committee must assert itself, forcefully, on behalf of the liquidation provisions set forth in H.R. 3838.

These provisions, which modify current Subchapter C rules, provide a closely-held corporation exemption. This exemption should be preserved since it enables small business owners to transfer their businesses without penalty -- an incentive which is important, in our view to stimulating entrepreneurial development.

VIII. EFFECTIVE DATES

One of the major difficulties of the President's proposal is the staggered effective dates it proposes. While many of the most important corporate base-broadening provisions are effective on January 1, 1986, the reduction in corporate tax rates does not take effect until six months later. The delay in the effective date for corporate rate reduction would have a serious negative effect on corporate cash flow. Hence, NAW believes that all elements of tax reform should become effective simultaneously. Any other approach is both unfair and unwise. H.R. 3838 wisely takes tnis approach.

We would, note, however, that whether one supports or opposes tax reform, it is clear that uncertainties about its passage are clouding investment and business decisions. For that reason, NAW believes that the effective date of tax reform legislation should be a date certain in the future.

Hence, Mr. Chairman and members of this Committee, we believe that you should help to move the process ahead so that taxpayers are treated more equally -- and more equitably -- than under current law.

IX. CONCLUSION

Mr. Chairman and members of the Committee, on behalf of the National Association of Wholesaler-Distributors, I would like to again commend you for your leadership in examining the impact of tax reform on small business.

More can always be done and, as made apparent by our testimony, we do not think that either the President's proposal or H.R. 3838 are perfect legislation. But, at least in the case of the latter, it has been forged in the political process and that in and of itself recommends much about it.

Moreover, NAW strongly believes that if you actually "run the numbers," as we have throughout the entire process, it is difficult to objectively argue with the fact that the House bill is favorable for the vast majority of smaller businesses. Hence, NAW believes that the Senate should work on improving that bill and on passing it.

As stated at the outset of this testimony, tax reform is clearly necessary and NAW believes that either the President's proposal in the form in which it was released last May, or H.R. 3838, would be substantial improvements over current law.

I would like to make a final point. One of the most widely heard criticisms from opponents of both the President's proposal and H.R. 3838 is that it unfairly burdens certain taxpayers. We submit that, in most cases, such criticism lacks merit. For many of those offering such criticism, they are only burdened relative to the current tax code under which they are extremely favored.

APPENDIX A

National Wholesaler-Distributor Organizations Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors Association
American Supply Association
American Traffic Safety Services Association, Inc.
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Associated Wire Rope Fabricators
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Arts Federation International
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
  National Kitchen & Bath Association

Door & Hardware Institute

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association

General Merchandise Distributors Council

Health Industry Distributors Association
Hobby Industry Association of America

Independent Medical Distributors Association
Institutional & Service Textile Distributors
  Association, Inc.
International Sanitary Supply Association
Irrigation Association
International Truck Parts Association
Jewelry Industry Distributors Association

Machinery Dealers National Association
Material Handling Equipment Distributors Association
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association for Hose &
  Accessories Distributors
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National & Southern Industrial Distributors Associations
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
North American Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Spring Service Association
Steel Service Center Institute

Textile Care Allied Trades Association
Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association
Video Software Dealers Assocation

Wallcovering Distributors Association
Warehouse Distributors Association for
  Leisure & Mobile Products
Water and Sewer Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance
Woodworking Machinery Distributors Association

APPENDIX B

November 18, 1985

The Honorable Dan Rostenkowski, Chairman;
Members of the Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman and Members of the Committee:

The historic opportunity to accomplish meaningful tax reform now before Congress should not be allowed to slip away. When President Reagan and you, Mr. Chairman, committed yourselves to reform of the tax system, you did so in the name of economic efficiency and fairness, principles that we have long advocated and worked to refine. Those principles are best achieved by lowering tax rates and broadening the tax base without sacrificing revenue. These goals must be reasserted now before the tax reform process becomes just another political struggle to determine who pays and who escapes taxation.

All of the distortions, inequities, ambiguities, and compliance problems associated with an income tax are exaggerated by high rates. The most important issue facing the Ways and Means Committee in the next few critical weeks is whether tax rates can be held down close to the levels proposed by the President.

Although some others have argued that high rates are desirable because they make tax incentives more valuable, we believe that the most powerful and efficient incentives are market forces, not tax provisions. By far the most productive "tax incentive" would be to have the lowest possible rates.

To cut rates without reducing revenue, we must substantially broaden the tax base. Our constricted tax base has caused high-productivity investments in heavily taxed activities to lose out to low-productivity investments in tax favored activities. It has also prompted many companies to reorganize and enter lines of business that they would never consider otherwise. It has diverted valuable attention and resources from innovation and careful management to tax planning.

Base broadening requires the accurate measurement of income. That goal can be achieved only if Congress adopts a realistic depreciation system related to actual depreciation experience of tangible assets. The Committee should terminate the investment tax credit and other provisions that direct capital into activities that cannot survive the test of market profitability. The short-run stimulus for which these provisions were designed should now be traded for a more balanced long-run strategy for sustained economic growth based on low tax rates.

The process of reforming the Nation's income tax laws is at a critical stage. The line must be drawn now in favor of low rates and a broad based system. If the Ways and Means Committee cannot accomplish this in the next few weeks, it will have lost the historic opportunity that is within its grasp.

Yours sincerely,

Charles R. Hulten
Charles R. Hulten
Professor and Chairman
Department of Economics
University of Maryland

Henry Aaron (Key)
Henry Aaron
Senior Fellow
Brookings Institution

Joseph A. Pechman
Joseph A. Pechman
Senior Fellow
Brookings Institute

E. Cary Brown
E. Cary Brown
Professor of Economics
MIT

Alan J Auerbach
Alan J. Auerbach
Professor of Economics
University of Pennsylvania

Robert E. Lucas
Robert E. Lucas
Professor of Economics
University of Chicago

John H. Makin
John H. Makin
Director, Fiscal Policy Studies
American Enterprise Institute

Harvey Galper (Key)
Harvey Galper
Senior Fellow
Brookings Institution

Joseph J. Minarik
Joseph J. Minarik
Senior Research Associate
The Urban Institute

Robert Eisner
Robert Eisner
William R. Kenan Professor of Econ.
Northwestern University

Robert J. Gordon
Robert J. Gordon
Professor of Economics
Northwestern University

Arnold Harberger Jr.
Arnold C. Harberger, Jr.
Professor of Economics
University of Chicago

George Break
George Break
Professor of Economics
University of California, Berkeley

APPENDIX C

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
the national voice of wholesale distribution

1725 K Street, N.W.
Washington, D.C. 20006
202/872-0885
Dirk Van Dongen
President
Direct Dial: 202/728-7674

March 15, 1985

The Honorable Ronald A. Pearlman
Assistant Secretary for Tax Policy
Department of the Treasury, Rm. 3120
15th & Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Ron:

In our previous discussions regarding the negative impact of the elimination of graduated corporate rates, you requested that we provide you with an analysis of the impact of the Treasury proposal on smaller wholesaler-distributors based upon actual tax returns.

Enclosed is a report prepared for us by Arthur Andersen & Co. which utilizes the type of analysis which you requested.

Arthur Andersen & Co. analyzed some 50 sets of income tax returns forwarded directly to them by members of our association requested by us to do so.

The firms targeted by us in our request were those whose sales volume suggested a pre-tax earnings level such that the graduated rate structure presently in place meaningfully impacted their effective tax rate.

In this regard, it needs to be emphasized that the overwhelming majority of wholesaler-distributor corporations have less than $5,000,000 in annual net receipts. Indeed, as the Arthur Andersen analysis points out, some 94 percent of wholesaler-distributor and retail corporations have net receipts under $5,000,000.

A typical $5,000,000 wholesaler-distributor has profits-before-tax of 3 percent, or $150,000. The effective tax rate on this amount of earnings is about 33 percent under current law. Firms with pre-tax earnings less than $150,000 currently have effective tax rates lower than 33 percent.

* * * * * * * * *

As you will see, the Arthur Andersen analysis has two principal conclusions:

1. THE TREASURY PROPOSAL'S PROVISIONS PRODUCE A VERY NEGLIGIBLE CHANGE (LESS THAN 1 PERCENT) IN THE RESPONDENTS' TAXABLE INCOME . . . THAT IS TO SAY THE PROPOSED CHANGES, WITH THE EXCEPTION OF THE RATE PROPOSAL, HAVE A NEUTRAL IMPACT ON TAXABLE INCOME, WHEN TAKEN TOGETHER.

2. THE PROPOSED FLAT 33 PERCENT RATE DRAMATICALLY INCREASES THE TAX OBLIGATION, AND THUS THE EFFECTIVE TAX RATE, OF THE FIRMS IN THE SAMPLE.

   INDEED, THE EFFECTIVE TAX RATE OF THE FIRMS IN THE SAMPLE WOULD RISE BY AN ASTONISHING 60 PERCENT, I.E., FROM 21 PERCENT UNDER CURRENT LAW, TO 33 PERCENT UNDER THE TREASURY PROPOSAL.

This analysis underscores the fundamental importance of retaining a graduated approach as you move to reduce the maximum corporate rate to 33 percent, a proposal which we strongly endorse.

I hope you find the information set forth in the enclosed to be enlightening. To us, it makes a strong and compelling case for modification of the Treasury proposal to continue a graduated rate for smaller concerns. To fail to do so would, at least in our case, make it extremely difficult for us to support the Treasury proposal. This would be most unfortunate given the strong identification of our members with the goals underlying this initiative.

Your continued attention to our concerns is greatly appreciated.

Best regards,

Dirk Van Dongen
President

Enclosure

cc: The Honorable James A. Baker
The Honorable Richard Darman
The Honorable Bruce Thompson
The Honorable Margaret Tutwiler
Nicholas E. Calio

ARTHUR ANDERSEN & CO.

OFFICE OF FEDERAL SERVICES

1666 K STREET, N.W.
WASHINGTON, D.C. 20006
WRITER'S DIRECT DIAL NUMBER

(202) 862-3206

March 15, 1985

Mr. Dirk Van Dongen
President
National Association of Wholesaler-Distributors
1725 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Van Dongen:

Under the Treasury Department's "Report on Tax Reform for Fairness, Simplicity and Economic Growth" (hereinafter the Treasury Proposal), it is proposed that the federal corporate income tax rate be a flat 33%. For small-to-medium-size corporations that are substantially affected by the graduated tax rates allowed under current law on taxable income up to $100,000, this proposal would result in a tax increase, unless the increase in tax rates on lower income levels were offset by a corresponding decrease in taxable income for these companies by virtue of the impact of other provisions contained in the Treasury Proposal.

You requested that we analyze actual tax return data of a group of small-to-medium-size wholesaler-distributor corporations to determine whether other provisions in the Treasury Proposal would indeed cause an offsetting decrease in taxable income.

For this analysis, approximately 2,500 wholesaler-distributors received requests from the National Association of Wholesaler-Distributors (NAW) to furnish, directly to us, complete federal income tax returns for their two most recent taxable years. This group of corporations was not intended to be a randomly selected sample of all corporations in the wholesale distribution industry and should not be construed as representative of the industry in general. Instead, the sampling of firms was limited to corporations whose net receipts NAW estimated were less than $5 million, i.e., those corporations that most likely were substantially affected by the present graduated tax rate structure. It should be noted, however, that according to the Statistics of Income - 1981, Corporation Income Tax Returns, approximately 94% of wholesaler-distributor and retailer corporations have net receipts under $5 million.

Up to the cut-off date of this study, we received responses from 107 corporations. Of these 107 responses, 50 were utilized in our analysis. The remaining 57 were rejected because the returns reflected net operating losses or because they were incomplete or otherwise lacked sufficient information to enable us to make an accurate comparison between the Treasury Proposal and current tax law.

SUMMARY OF RESULTS

The 50 wholesale distribution corporations analyzed have the following characteristics:

Average Taxable Income (current law)	$ 62,985
Average Pre-Tax Book Income	$ 65,558
Average Net Receipts	$2,873,352
Average Total Assets	$1,006,941

Taxable Income

Our analysis indicates that, for the 50 wholesale distribution corporations analyzed, average taxable income under the Treasury Proposal would be $62,594. This amounts to a negligible decrease (i.e., 0.6%), from their average taxable income under current tax law. This change is the net result of increased taxable income due to indexation of indebtedness (i.e., most corporations are net borrowers), revisions in the cost recovery system and the repeal of the reserve method for bad debt deductions, offset by a decrease in taxable income due to the indexation of inventories for corporations using the first in, first out (FIFO) flow of goods assumption.

Tax Liability

With respect to taxes due, our analysis indicates these corporations would have a 59.8% average increase in tax due under the Treasury Proposal (and an increase in their average effective tax rate from 20.7% to 33.2%*). Since the change in taxable income would be relatively insignificant under the Treasury Proposal, the increase in tax due is attributable almost entirely to the proposed change in the tax rates as well as to the elimination of tax credits (primarily the investment tax credit) allowed under current law.

In this regard, it should be noted that the corporations' average tax liability would still increase 37%, even if there were no change in the investment tax credit under the Treasury Proposal.

Our analysis is attached in the following two exhibits:

- Exhibit I - Summary of results.
- Exhibit II - Summary of data from the actual tax returns.

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* The tax rate under the Treasury Proposal exceeds the proposed 33% rate due to recapture of investment credit claimed in prior years.

In computing the changes under the Treasury Proposal, it was necessary to make certain assumptions that would allow us to complete the project in an efficient manner while not jeopardizing its accuracy. These assumptions are an integral part of this analysis and are attached as Exhibit III.

ELECTION UNDER SUBCHAPTER S

You have asked whether, should the Treasury Proposal become law, election of S corporation status would be a viable means for corporations to avoid the increase in taxes that might occur as demonstrated by the analysis summarized above.

There are substantial limitations to widespread use of S corporation status by operating businesses:

1. Utilization of an S corporation places a number of limitations on the overall structure of the business.

   For example, many small businesses operate more than one business or operate one business in multiple locations. There are often compelling reasons for each business or each location to be incorporated separately (e.g., liability, state and/or municipal laws and licensing rules, incentive compensation arrangements for personnel associated with only one business or location, etc.). However, since an S corporation cannot be a member of an affiliated group, the desired legal structure could only be achieved through the use of a C corporation.

In addition, the owner of the business may wish to share the ownership with family members, particularly children or grandchildren, whose age or lack of maturity may preclude certain distributions of income. In these instances, stock ownership must be by a complex trust that accumulates income. However, complex trusts cannot be shareholders in an S corporation and, as a result, a C corporation would be required.

Further, an S corporation can only have one class of stock outstanding and, therefore, cannot issue preferred stock. Consequently, S corporation status is not a practical alternative where differing ownership interests require certain preferences as to current earnings and/or liquidation distributions. In these cases differences in voting rights allowed for common stock are not sufficient to reflect different levels of capital contributions relative to the percentage of ownership or the business talent of the owners.

There are other limitations on the number and types of shareholders permitted for an S corporation. Thus, for corporations with more than 35 shareholders or whose shares are owned by a corporation, S corporation status is not available. It should be noted that, while the 35-shareholder limitation is not a substantial impediment for newer, small corporations, it can become a problem for those that have been family-controlled for a number of years and whose stock may now be dispersed among many family members due to sales (to raise additional capital), gifts and inheritances.

Finally, the stock of an S corporation may not be held, generally speaking, by a trust. Hence, an S corporation election could not be made by a company that has, or intends to, set up an employee stock ownership trust for purposes of transferring to the employees an equity interest in the business.

2. A second concern would be that certain limitations under the tax law not applicable to a C corporation might apply if S corporation status were elected, thereby increasing the effective tax rate on the corporation's income.

For example, under the Treasury Proposal, net interest expense incurred by a C corporation is fully deductible in computing taxable income (subject to the proposed interest indexing provisions). If the corporation elects S corporation status, however, the net interest expense would be treated, under the Treasury Proposal, as investment interest of the shareholders if they were not actively engaged in management.

The Treasury's proposed limitations on deducting investment interest would then apply and the effective tax rate on the S corporation's net income could substantially exceed the proposed 33% rate for C corporations. Thus, S corporation status might not be a viable alternative for a company that is growing and needs to maximize retained earnings for the expansion of the business.

3. The third area for concern relates to the limitation on the selection of taxable years for an S corporation. A business may have a natural business year, but not one that will meet the tests provided under Internal Revenue Service guidelines to permit adoption of a tax year that is different from that of the shareholders. The ability to select a yearend that fits the nature of the business operation may be more important than the benefits of S corporation status and, therefore, dictates the choice of C corporation status.

4. The final area of concern is the status of the income tax law at the present time. To date, there are no regulations in effect on the operating rules for S corporations. The lack of these regulations causes many small business owners to be concerned with whether they can operate under Subchapter S without the adverse tax consequences of an inadvertent violation of the operating rules. Further, although the Subchapter S Revision Act of 1982 simplified and clarified Subchapter S in many ways, the law is still far from simple and contains numerous potential traps. Many small business owners and their tax advisors are not sophisticated in their tax knowledge and, as a result, shy away from Subchapter S because of fear of the unknown.

* * * * * * * *

We appreciate the opportunity to provide you with our analysis of the impact of the Treasury Proposal on the wholesale distribution industry.

Very truly yours,

Arthur Andersen & Co.

lmh

EXHIBIT I

IMPACT OF TREASURY PROPOSAL ON SAMPLE COMPANIES IN WHOLESALE DISTRIBUTION INDUSTRY

SUMMARY OF RESULTS

ASSUMPTIONS:

Inflation Rate	5%
Interest Exclusion Factor	45%

SAMPLE PARAMETERS:

Number of Corporations Sampled	50
Average Total Assets	$1,006,941
Average Net Receipts	$2,873,352
Average Capital	$ 96,831

COMPUTATIONS:

	1ST YEAR	2ND YEAR	AVERAGE	PERCENT OF CURRENT LAW TAXABLE INCOME
I. Change in Taxable Income:				
Average Taxable Income (Current Law)	$63,236	$62,734	$62,985	100.0%
Average Adjustment				
Increase (Decrease) Due To:				
Indexed Interest	11,737	9,205	10,471	16.6
RCRS	2,228	5,807	4,018	6.4
Indexed FIFO Inventory	(16,356)	(17,098)	(16,727)	(26.5)
Disallowed Bad Debt Reserve	1,872	1,821	1,847	2.9
	======	======	======	======
Average Taxable Income (Treasury Proposal)	$62,717	$62,469	$62,594	99.4%
	======	======	======	======
Average Percent (Decrease)	(0.8%)	(0.4%)	(0.6%)	
	=======	=======	======	

COMPUTATIONS: (Continued)	1ST YEAR	2ND YEAR	AVERAGE
II. Change in Tax Due:			
Average Tax Due Current Law (Sch.A)	$13,032	$12,987	$13,010
Average Tax Due Treasury Proposal (Schedule A)	$20,824	$20,746	$20,785
Average Percent Increase in Tax Due	59.8%	59.7%	59.8%
III. Average Effective Tax Rate:			
Based on Taxable Income - Current Law	20.6%	20.7%	20.7%
Treasury Proposal	33.2%	33.2%	33.2%
Percent Increase in Effective Tax Rate	61.1%	60.4%	60.8%
Based on Financial Statement Income - Current Law	19.7%	20.0%	19.8%
Treasury Proposal	31.5%	31.9%	31.7%
Percent Increase in Effective Tax Rate	59.8%	59.7%	59.8%

IMPACT OF TREASURY PROPOSAL ON SAMPLE COMPANIES IN WHOLESALE DISTRIBUTION INDUSTRY

SCHEDULE A	AVERAGES					
	1ST YEAR		2ND YEAR		TOTAL	
SUMMARY OF AVERAGE TAXABLE INCOME AND TAX DUE	CURRENT LAW	TREASURY PROPOSAL	CURRENT LAW	TREASURY PROPOSAL	CURRENT LAW	TREASURY PROPOSAL
TAXABLE INCOME	$63,236	$62,717	$62,734	$62,469	$62,985	$62,594
INCOME TAX	$15,471	$20,697	$16,108	$20,615	$15,790	$20,656
OTHER TAXES	275	275	309	155	292	215
CREDITS	(2,714)	(148)	(3,430)	(24)	(3,072)	(86)
TAX DUE	$13,032	$20,824	$12,987	$20,746	$13,010	$20,785
PERCENT CHANGE		59.8%		59.7%		59.8%

EXHIBIT II

IMPACT OF TREASURY PROPOSAL ON SAMPLE COMPANIES IN WHOLESALE DISTRIBUTION INDUSTRY

SUMMARY OF DATA FROM ACTUAL TAX RETURNS

FORM 1120	FORM 1120 (LINE)	AVERAGES YEAR 1	 YEAR 2	 COMBINED
PAGE ONE				
Total assets	F	$ 958,375	$1,055,506	$1,006,941
Net receipts	1(c)	2,698,671	3,048,033	2,873,352
Interest (income)	5	110,619	10,793	10,706
Interest (expense)	18	36,442	31,043	33,742
Depreciation	20	37,843	44,424	41,133
Taxable Income	30	63,236	62,743	62,985
SCHEDULE A				
Inventory (BOY)	1	642,505	394,836	518,670
Inventory (EOY)	6	395,223	449,320	422,272
LIFO (1)				
SCHEDULE E				
Current provision	Column 4	5,534	7,735	6,635
Current amount charged	Column 6	5,853	6,763	6,308
SCHEDULE J				
Income tax	3	15,471	16,108	15,790
Investment credit	4b	2,513	3,398	2,956
Jobs credit	4c	53	8	30
ESOP credit	4d	0	0	0
Research credit	4e	148	24	86
PHC tax	7	0	0	0
Tax on prior ITC	8	275	247	261
Minimum tax	9	0	62	31

IMPACT OF TREASURY PROPOSAL ON SAMPLE COMPANIES IN WHOLESALE DISTRIBUTION INDUSTRY

SUMMARY OF DATA FROM ACTUAL TAX RETURNS

		AVERAGES		
FORM 1120 (Continued)	FORM 1120 (LINE)	YEAR 1	YEAR 2	COMBINED
SCHEDULE L				
Capital Stock	21	$73,746	$93,103	$83,424
Capital Surplus	22	12,264	14,548	13,406
SCHEDULE M-1				
Net income per books	1	52,697	52,831	52,764
Federal Income tax	2	13,318	12,269	12,793

	YEAR 1		YEAR 2		TOTAL	
FORM 4562	COST	DEPRECIATION	COST	DEPRECIATION	COST	DEPRECIATION
NEW ADDITIONS						
3 yr/Class 1	$11,120	$ 2,737	$ 9,937	$ 2,304	$10,529	$ 2,520
5 yr/Class 2	1,211	182	667	102	939	142
5 yr/Class 3	1,030	154	170	26	600	90
5 yr/Class 4	13,106	1,956	30,843	4,622	21,975	3,289
10 yr/Class 6	53	4	25	2	39	3

EXHIBIT III

IMPACT OF TREASURY PROPOSAL ON SAMPLE COMPANIES IN WHOLESALE DISTRIBUTION INDUSTRY

Remarks and Summary of Significant Assumptions

1. Due to the level of detail provided in an income tax return, the only adjustments between current tax law and the Treasury Proposal made in our analysis were:

    - Corporate tax rate of 33%.
    - Repeal of investment tax credit.
    - Repeal of jobs tax credit.
    - Repeal of the corporate minimum tax.
    - Indexation of interest income and expense.
    - Indexation of inventories for those corporations currently using FIFO.
    - Real Cost Recovery System (RCRS) depreciation.
    - Repeal of the reserve method for bad debt deductions.

    It should be noted that other adjustments may be required, but due to the lack of detail available, they were not included in our analysis. For example, an adjustment for the proposed limitation on deductions for entertainment and business meal expenses could not be determined due to lack of information provided in the tax returns.

2. All changes were assumed to be fully phased-in in the first year of the analysis.

3. For purposes of the various, proposed indexation provisions, the annual inflation rate in each year was assumed to be 5%.

4. For cost recovery purposes, it was assumed that all current-year additions and retirements occurred on July 1. Further, all five-year recovery period assets under the accelerated cost recovery system that were not described in detail in the tax returns were assumed to fall into Class 4 of the RCRS asset classes.

5. For purposes of indexing FIFO inventory, it was assumed that 10% of the items in beginning inventory were discontinued during the year and that 10% of the items in ending inventory were added during the year.

   Due to lack of information, it was impossible to determine which items carried in inventory throughout the year increased or decreased in number. (This information is needed to calculate precisely the adjustment for indexed FIFO inventory under the Treasury Proposal.) Therefore, the inventory adjustment was computed on an aggregate basis by assuming that the individual items within the inventory all either increased or decreased during the year. It should be noted that this assumption generally overstates the benefit of the Treasury Proposal for indexed FIFO inventories.

6. For purposes of indexing FIFO inventory, no attempt was made to reflect an inventory turnover rate. Based on informal discussions with Treasury, the indexation of FIFO inventories may be affected by the number of times inventory turns during the taxable year. However, no information as to how this adjustment should be computed has yet been made available. If an adjustment is required, it would tend to increase the tax due under the Treasury Proposal. Consequently, a conservative approach has been adopted by not making an adjustment for inventory turnover.

7. Investment credit recapture reported by the companies was treated as an additional tax under the Treasury Proposal insofar as it related to the disposition of assets acquired prior to the first tax year analyzed. The resulting additional tax for some companies accounts for the fact that their effective tax rate under the Treasury Proposal exceeds the flat 33% tax rate.

8. Under the Treasury Proposal, the definition of qualified research for purposes of the research and development (R & D) credit would be revised to target those research activities likely to result in technological innovations. For purposes of our analysis, it is assumed that the R & D credit claimed by each company would be unchanged under the Treasury Proposal.

9. No assumptions were made regarding changes in the type or level of business activity that the companies might adopt in response to the assumed change in tax law.

10. The information utilized in the analysis was accumulated from tax returns supplied by the 50 companies used in the sample. The engagement did not include the verification of the correct application of federal income tax laws in effect for the covered years or the accuracy of the data contained in the returns. Accordingly, no opinion is expressed regarding the accuracy of the data supplied.

The **Chairman**. Thank you very much, Mr. Smith. We'll have questions in a minute.

The last witness is Mr. John Satagaj, president of the Small Business Legislative Council.

STATEMENT OF JOHN S. SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. **Satagaj**. Thank you, Mr. Chairman. It's a pleasure to be here. I've appeared before this committee before, but this is my first time in my new capacity as president of SBLC.

We are a coalition of 88 trade associations, all small business associations, and I want to say this tax reform debate has been one of the most difficult things we have gone through as a coalition. The process is difficult because this bill not only cuts between big and small business, but also horizontally between industries. What makes SBLC work is also what gives it the most difficulty. We represent a diverse group of people. We bring them together and focus attention on the diversity as well as the common interest.

I have a full written statement which is in the record. I just want to highlight eight major points very briefly that are of concern to us.

No. 1 is even if you addressed all the issues of fairness between big and small business, we come down to the fact that H.R. 3838 still shifts the burden from the personal side to the business side to the tune of $140 billion. That is troublesome to a majority of the members of the SBLC. It's a difficult thing for them to handle.

Frankly, we have a large group, a majority, that would like to see not only the rate cuts, but investment incentives altered to address that problem. There is a substantial minority concerned about rate cuts alone, and they have good reason. They pay a very high effective tax. So the issue within SBLC has been framed along those lines.

For these reasons, one of the proposals we have endorsed has been developed by the National Grocers Association, to implement a tiered ITC, investment tax credit. Essentially it phases out as the level of assets grows.

We feel it is very important. In fact, the interest we hear from our members and our member associations surprises us. There has been an increasing amount of interest in the impact of H.R. 3838 on investment incentives. It is our No. 1 concern.

No. 2 is an issue not addressed in my written testimony but which is of great concern to us, and it is the recapture provisions which Mr. Smith just talked about for the corporate rates over $100,000 of taxable income. What works out between the area of $100,000 in income to $365,000 is that you are effectively paying a marginal rate of about 41 percent when you kick in the recapture provisions. So, between $100,000 and $365,000, that marginal dollar is being taxed. Granted it is rarefied air up there; there aren't that many small businesses getting there, but when they reach this level, they are the ones that are going through the real growth process. Those are the ones we want to create the jobs. I think you have to look closely at the recapture provision and what it is doing to those small businesses as they get to that growth area.

No. 3, of course, is capital gains. The differential in capital gains is very important to corporate investment and innovation and job creation. I think any bill which moves forward must address this issue. Right now H.R. 3838 does not do that.

The fourth issue is data. One of the big problems we have, of course, is there are only two sources of data when you want to analyze this bill realistically: the Department of Treasury and the Joint Tax Committee. I think this committee could do a great service to the small business community if they helped us get data. We need it. It's very difficult to conduct an analysis without it.

The fifth area is the question which somebody asked earlier: What is our priority? Our priority is deficit reduction before tax reform, which brings me to the next area: Tax stability is still a big issue for small business. If we are going to have change, it's going to have to be true tax reform. I think the small business community, as we have heard it through SBLC, has said they are willing to go through this whole thing one more time if we are going to achieve something.

Since 1981 we have not let a business plan run its full strategy. We keep altering the program. A business can't plan. We feel tax stability has to override everything we're talking about. So if it comes to yes or no, current law versus H.R. 3838, we're going to take current law because it is at least going to give us tax stability at this time.

Those are the major issues in front of us. I think in my testimony I highlight some of those issues you can address if you want to make this bill fair between big and small businesses, but I think before you get to those questions you have to answer some of these threshhold questions that we now see are on the table.

I thank you for the opportunity, Mr. Chairman, to present our views.

[The prepared statement of Mr. Satagaj follows:]

Small
Business
Legislative
Council®

Testimony of John S. Satagaj, President
Small Business Legislative Council
Before the Committee on Small Business
U. S. Senate
February 6, 1986

It is a pleasure to appear before the Committee today on behalf of the Small Business Legislative Council (SBLC) today to discuss the subject of tax reform. My name is John Satagaj and I am the President of SBLC. We are a coalition of eighty-eight associations who represent approximately four million small businesses.

The debate surrounding tax reform has been a difficult one for us but one which we believe demonstrates the value of dialogue in a group like ours. As an assembly of associations, the diverse range of interests within the small business community are accentuated because they are drawn into tighter focus by the member groups. The diversity of concerns should come as no surprise to anyone since it merely reflects the dominant role small business plays in nearly every sector of economy.

SBLC works because the factors which highlight the differences quickly identify the common concerns and they are all attributable to our common denominator-small business. We have never disbanded a meeting for lack of issues on which to work.

I want to present this background as I feel it is important to understand how we got to the point at which we are today.

Before I discuss some of the issues of concern to SBLC, I must highlight one procedural problem which the Committee could help resolve for the small business community. We lack the hard data necessary to make the proper evaluation of tax reform proposals. Much of the raw data necessary to analyze the impact of tax proposals must come from one of two sources, either the Department of the Treasury or the Joint Committee on Taxation. Second, the small business community, as a whole, does not have the resources to do the sophisticated econometric analysis of the data, if it is made available.

The data which has been made available up to this point has not been in a form to make a meaningful analysis of the impact on small business.

It has always been our attitude we should attempt to assemble as much information as possible and approach this Committee with specific suggestions and solutions. The tax area, as the result of the limited sources of data, does not lend itself to this process. This Committee could be of major assistance to the small business community in this tax debate simply by helping us obtain the data we need to analyze the proposals on the table.

We started this process as ardent supporters of tax reform and we were confident President Reagan could achieve this goal. We supported his plan but we did note from the outset some small business dominated industries had reservations which we believed could be addressed without major alterations. There were some associations who had major objections based on their own economic circumstances. Throughout the process of development of a bill in Ways and Means, we continued to hold to the belief tax reform was an achievable goal and we would work to identify sub-issues which would make it a balanced bill for a small business. The Ways and Means Committee did address these concerns and made some significant improvements. In other areas, we were disappointed.

Our member associations have now had time to digest the impact of the bill. I would be less than candid if I didn't tell you there remains a significant split within the community with industry groups strongly in support of the House passed bill and others in opposition, with a group in the middle.

The central problem is the major issues presented by the bill are not framed in terms of big and small but must be viewed horizontally, industry by industry. The result is you find yourself asking, "Is this good because it is good for small business or because it is good for a particular industry dominated by small firms?"

It may be heretical to say, but the best answer might have been to have everyone close their eyes, count to ten, and have a sweeping tax bill in place. Of course, not everyone would cooperate, and as a result, we are all forced to play the game.

We have tried hard to look at this bill from three different angles. The first is the macro level. What does this do for the economy? Will the average tax payer benefit? Will it create a stronger consumer demand for products? What will it do for investment, expansion and development? Second, to the extent possible, does it treat big and small businesses fairly? Finally, does it create hardships for particular small business industries to the extent we could not absorb the impact?

Chairman Packwood has indicated that he intends to start from scratch in the Finance committee. There are several elements which should be included in the bill to ensure a balanced bill as it effects small versus big business. Some of these factors were included in the President's bill, others were added in the Ways and Means bill, still others are on the table.

We would venture to say most small firms view the tax code as a hindrance rather than a help, and are ill equipped to mine the mother lode of the current code in such a ready fashion as those with the resources (and the battery of accountants and lawyers) on hand to do so.

At the same time, small business has long recognized the value of the tax code to promote capital formation and retention. The more growth-oriented you are, the more you come to appreciate the value of sound economic based tax policy. Capital, whether for a new start or an expansion, does not come easily to small business. Financial markets (whether at home or abroad) don't provide the favorable rates or even the access to credit we need. Likewise, small business can seldom rely on large institutional investors to provide equity. Much of our capital comes from small investors, from retained earnings, or from a select group of institutions that specialize in small business financing, and tax policy has a tremendous influence on the flow of dollars from these sources.

The converging, as well as conflicting, aspects of these two forces come together within the context of this debate. How do we develop a fair, neutral equitable tax that still encourages the growth of small business?

Of a universe of 14 million small businesses, there are many "businesses" being conducted as sole proprietorships. As the President noted, when he introduced his bill, they would surely benefit from a reduction in marginal personal rates. These are the classic mom & pop's, whose primary ambition is to make an honest living and pursue their dream of economic freedom. For them, simplification (i.e. personal rate reduction) is an answer to their frustration and anxiety. For these smallest of businesses, the personal rate structure of H.R. 3838 is a net gain.

There is one other advantage of a simplified, lower personal rate that should be highlighted. Study after study have consistently demonstrated that the principal source of small business start-up funds is the informal network of family and friends. Recently, the small business column in the Wall Street Journal chronicled, once again, small business' dependence on such investment and the frustrations of location these investors.

To the extent we can provide a stimulus for additional investments by this informal network, we are achieving a positive gain for small business. If lower personal rates put more funds into the hands of these investors then that is a positive gain for small business.

At the other end of the spectrum is the sophisticated growing business, a true engine of job creation. For that growth firm, once they have gotten beyond the early birth stages of the business, a sole proprietorship form or even a S Corporation form can be a hindrance to capital formation and retention. From a purely business point of view, the marginal personal rates have little to do with that type of business.

For the growth-oriented small business the C corporation provides the flexibility and structure to acquire new capital and retain earnings necessary for expansion. Year after year, small business had made a graduated corporate rate structure its number-one policy goal.

As you will recall, the number one priority of the 1980 White House Conference on Small Business was - "Replace the present corporate and individual income tax schedules with more graduated rate scales, specifying the graduated corporate tax scale up to $500,000." The 1984 National Issues Conference also voted graduated rates as their third priority behind deficit reduction and government competition; and our own SBLC Issues Conference, held in January of 1985, also voted this a high priority. We were pleased to see the President recognize the importance of the graduated corporate rate and has included a graduated scale in his proposal. The modifications in the lower end of the rate scale made in by the Ways and Means Committee are a significant improvement, provided you consider rates alone. The priority placed upon rates in the past must be considered in the context of the remaining portions of the code, particularly those which influence capital investment. We will discuss that subject at length in this testimony.

As to the topping off of the structure at 33%, 35%, 36% or 38%, there are positive and negative ramifications for a growth oriented firm. From one perspective, an extended progressive rate structure allows a growth oriented firm to compete against established firms during the growth years. On the other hand, the prospects of leveling off at a lower rate than in present law has to be appealing to a growth oriented firms as retained earnings do play a vital role in expansion of existing businesses. For many industries, dominated by small firms, with a high effective rate, these cuts are of major importance. Within SBLC, we do have industries which are supportive of the President's and the Ways and Mean's bills on this basis.

The second area of interest in any proposal deals with the rate differential on long-term capital gains rates. SBLC strongly believes that almost the sole motivation for outside investment in new and growing businesses comes from that tax differential. Clearly, investing in such companies is a risky undertaking. Successful investments hold the potential for major returns, but there are more losers than winners in the portfolios of these outside investors.

The long-term capital gains tax differential provides the "equalizer" in offsetting the higher risk of investing in smaller firms. Again, we are pleased to note that the President not only saw fit to retain the capital gains incentives in his original package, but to lower the rate to 17 1/2 percent.

We found it of particular interest that the Administration's first preference appeared to be to craft a capital gains system which would encourage investment in small and innovative companies. Unfortunately, they encountered difficulties we know all too well in defining the particular activity or forms of investment which should enjoy such treatment. We hope the effort will not be abandoned completely, and we would certainly pledge to work on this effort. As you will recall, in 1980, the White House Conference voted the deferral of taxes for rollovers of investments affecting small business, and a tax credit for initial investments in small business as their sixth priority.

We have seen figures showing that 41% of the dollars dedicated to organized venture capital companies comes from corporate taxpayers. The President's proposal kept the corporate capital gains tax rate at the present 28% — and that is a very small differential from a top corporate tax rate of 33% or 38%. Under H.R. 3838 the tax rate of 28% for corporate net long term capital gains would be replaced and such gains would be taxed at ordinary income rates. For individuals, the House bill would reduce the deduction for net long term capital gain to 50% in 1986 and to 42% thereafter. The maximum capital gain rates would be 22%.

We believe your committee should come up with a better formula which will provide incentives for corporations to invest more dollars, not less, in venture capital for new and growing small business concerns.

Any proposal to limit further the use of cash accounting is of concern to us. We believe there is solid business management justification for the use of cash accounting by small businesses. We believe any proposal to put more firms on accrual accounting will create many problems for small firms and while a $5 million threshold alleviates some of the problems, at best, it is a postponement of the problem.

The Ways and Means committee did eliminate the so called "Financial Statement Conformity" rule proposed by the President which would have required businesses which use accrual on financial statements to use accrual for tax purposes. H.R. 3838 also permits service corporations to use cash accounting and small businesses dominate these service industries. These accounting provisions should be retained in any Senate bill.

Small contractors will permitted will be allowed to use the completed contract method of accounting under H.R. 3838. Many of our construction industry members support this retention of current law.

H.R. 3838 would repeal the reserve method, this would limit bad debt deductions to actual loan losses. For many industries dominated by small business such as business advertising this would be a serious problem.

H.R. 3838 would allow small businesses with average annual gross receipts of $5 million or less to elect to use a separate pool for major category of inventory items and to use a single published index for each pool. We view this as a positive step towards simplification of LIFO but would urge this Committee to explore additional steps to eliminate the perennial problems of inventory valuation for small businesses.

Employee benefits is becoming an important issue for labor intensive small business. As retirement security responsibilities shifts from the public to the private sector, and as small business' demand for highly skilled technical labor increases, so does our concern over the fate of the tax treatment of items as the 401(K) plans. In the past we have not devoted as much attention to this issue as we now believe should be given to it and we urge the Committee to follow developments in this area. R&D credits are important to our most innovative firms and we believe it should be continued.

This brings me to the final subject which bridges the gap between the micro issues of fairness between big and small and the macro issue of what this bill does for the economy and business growth.

As you know both the President's proposal and H.R. 3838 would eliminate the investment tax credit. In addition, H.R. 3838 would make substantial changes in the depreciation system for capital assets. We find major segments of the small business community are troubled by these changes. To be frank, the extent of this interest even surprises us. As I stated previously, assuming a static capital asset system, the proposed reduction in rates might have been sufficient for most small firms. However, given the suggested changes in the depreciation system and the complete elimination of the ITC, it is becoming very clear to us that a cut in rates alone is not the answer for a substantial number of our industries. Thus, while for many of our members the final level of rates is the primary concern, for many others it is not. Hence our dilemma. I can assure the Committee that we have looked long and hard at this dilemma, and that we have arrived at two initial conclusions. First, direct expensing, for which we have our long term supporters, must be an integral, meaningful element of any tax reform.

Second, some method of capital cost recovery through an investment tax credit is of vital importance to many growth oriented, expanding small businessmen and women. To this end, one of our members, the National Grocers Association, has advanced a conceptual plant to institute a modified, targeted ITC. The proposal itself is the essence of simplicity, and I have appended a full copy of it to my formal statement.

As noted, the concept is a straightforward one. It requires (1) the imposition of a *progressive* structure of investment incentives such that as investments *increase* the taxation credits attached to them would *decrease*. (2) The substantial reduction or elimination of credits at the upper end of the scale. Of course, the NGA statement includes a number of possible models for actualization of the concept. Consider only one, Model II, as an example. Under its structure the first $500,000 of investment purchases would receive an ITC of 10%; the second $500,000, 8%; the next three $500,000 increments would receive credits of 6%, 4%, and 2% respectively, with all additional investment purchases being eligible for a 1% ITC.

Certainly many possible modifications could be made such as adjustment of the investment purchase categories or an alteration in the rates of the investment credit itself. Any final determination will reflect a balance of investment stimulus efficiency with equity and cost considerations.

As a reflection of its very great concern in this matter the SBLC has voted to approve the NGA concept for inclusion in any new tax reform legislation.

The critical point is that there is an alternative to either outright repeal or retention of the investment tax credit. It seems clear to us that while may industries which are most interested in marginal rates, there is also a significant number who are concerned about the implications of this bill for investment incentives in the business community.

As I said this subject is the bridge between the micro and macro. H.R. 3838 is said to shift the tax burden from individuals to businesses to the tune of $140 million. Even if we are able to make modifications to the bill to distribute fairly this burden between big and small business, they are all going to be shouldering a significantly greater burden than before. Can we absorb such changes and continue to expand and grow? Many industries, such as tooling and machining, are being hard hit by foreign competition. Some of the incentives to be eliminated were their prime weapons in the fight to stay competitive. No one will argue with the desire to reduce the tax burden on the poor or the working class or to make certain everyone pays taxes on income. At the same time, we must keep the small business healthy and growing. Investment and innovation to go hard in hand. We have a contradiction. We do want tax reform but it must be tempered by our desire to use the tax system to encourage small business to be competitive to grow and to expand. Up to this point I have not mentioned another consideration which must be taken into account.

Tax stability is very important to small business. It is difficult enough to forecast sales and income without the constant shift in tax policy upsetting careful planned budgets. In just a half dozen years we have absorbed three or four major shifts in tax policy. I have had many small business owners come up to me and ask what do I do? "I think I can increase my sales 50-60% and I'll need four new trucks, my insurance premiums have doubled, tripled, we just set up a new pension program, but I've got it pencilled out and I believe I can swing it. How long can I count on this tax situation to remain the same? Otherwise we'll just scale down and take what business we can get pushing the current vehicles as far as we can go." How do we answer him without losing economic growth? Tax policy is very much on their mind. Many are willing to go around once more in the name of tax reform but we do believe we are pushing the limit. Tax stability must be a primary objective. We must stay with a system for sometime to allow individual business strategies to run their course.

Mr. Chairman, that concludes my remarks. As always we are available to work with the Committee. The challenges are formidable but we still believe we can achieve the goals of tax reform and small business growth. Thank you.

SMALL BUSINESS AND NATIONAL TAX REVISION PROPOSALS: 1986

Submitted by the National Grocers Association

I.Small Business.

The historical role of small business in our society is without question. Successful small business was the original "American Dream." It has continued for more than 200 years to serve as the vital backbone of our entire American free enterprise system. Should anyone doubt the role which small business now plays they need only review the last three annual "State of Small Business" Reports of President Reagan, or the more detailed "Annual Report on Small Business and Competition" submitted by the Small Business Administration. Their hundreds of pages point out that in our economic downturns it is small business which has been most resistant to economic decline, and in our present recovery it is small business which has distinctly been in the forefront. Whether measured by employment generation, expansion of sales, improvement in service innovation, or any other basis, small business has led the way.

Yet despite this prominence, any attempt to give meaning and definition to the term "small business" is a most difficult one. Depending upon the authority or report which is consulted "small business" may be measured by the size of the employed workforce, amount of assets, level of sales, totality of income, or other diverse categories. Who is right, who is wrong? It's hard to say. And yet, "we know it when we see it." Each day we inevitably encounter small businessmen and women from the corner drug store, to the local gas station to the neighborhood grocer or restaurant. All of them provide us with the services and products our life demands. In fact, in America today there is no simple definition of "small business." Rather what all of us see and rely upon, are hundreds and thousands of small businesses, each one with its own diverse set of characteristics and priorities.

Indeed, the only real generality which one can make about the small business community is that no generality is possible. This aspect needs to be stressed. Far too often public discussion, and that surrounding tax revision, has tended to treat "small business" as a single, monolithic entity about which sweeping universal judgements could be made. What was good for 51% of small business would automatically be "good" for all 100%. In reality, a more sophisticated approach would reveal that the total community consists of a diversity of segments. That is our specific concern within this report, to focus upon the proper role of government tax policy upon the progressive, growth and investment oriented segment of small business. This group of firms are still of vital importance to the entire nation and its particular problems and requirements must be positively addressed.

II. Present Deficiencies.

At the current moment the Senate Finance Committee and subsequently the Senate as a whole, is about to take up the issue of tax revision. Certainly the working basis for that discussion will be the collection of proposals embodied in the House passed bill, H.R. 3838. We would contend that far too little attention has been paid to a number of that legislation's potentially substantial impacts upon numerous small businesses. These impacts are of sufficient severity that they demand correction through constructive action by the Senate. In offering an analysis of various results to be expected from enactment of H.R. 3838 or similar legislation we rely upon illustrations drawn from the progressive independent retail grocery industry. Numerous examples from other segments of the economy could be similarly advanced. The grocers have been selected because of the convenience of our own data base, and because of their representative nature. As President Ronald Reagan noted on two separate occasions, "I cannot think of a better example of small businesses' contribution to our country's economic well being than that of the independent retail grocer." as well as the fact that we "still epitomize small business." From such a representative background our own analysis of the approach suggested in H.R. 3838 has concluded:

> The interaction of corporate rate reduction and Investment Tax Credit elimination is unwise. A careful examination of the revised rate structures clearly shows that most businesses are unable to take significant advantage of the most substantial reductions in corporate rates, those at the very highest end of the scale,. Yet they will suffer the loss of their one primary and most frequently utilized incentive to constructively compete and expand through modernization, format innovation, and store expansion-- the Investment Tax Credit. Obviously, the ultimate losers in such cases will be the store owners themselves, a vital segment of the grocery community, and their customers who have trusted them to provide the high levels of service and convenience which their expertise and community interest permits. In such circumstances the entire country loses.

No wonder that a recent comprehensive survey of the N.G.A. membership revealed that, "87% of the respondents said loss of the investment tax credit would slow or impede their business growth." In short, economic investment, vital to this industry and to the nation as a whole will be critically retarded or eliminated by total repeal of the ITC. As noted previously, while no claim can or should be made that this is true for every small business, it is especially true for the many who are most open to progress and expansion through investment improvements.

Furthermore, the interaction of corporate rate reduction and Investment Tax Credit elimination is unfair. Thorough examination of the data reveals that all businesses must surrender the Investment Tax Credit, but that the corresponding tradeoff--lower corporate income tax rates--benefit corporations in the highest bracket to a far greater degree. Thus the benefits of the rate interaction are not distributed progressively, but rather regressively. Moreover, one must understand that while the ITC may be a sometimes valuable accounting tool of larger businesses, it is often an essential feature of their smaller-moderate competitors providing vital financial assistance for progressive efforts to serve their customers. In short, by failing to allocate its burdens and benefits in an equitable, evenhanded manner, the Ways and Means bill fails fundamental tests of fairness.

No matter how frequently one may verbalize these conclusions they always seem more striking when confronted head on, in hard numerical form. As the following chart graphically demonstrates H.R. 3838 with its inequitable combination of rate reduction and elimination of the ITC greatly produces an unfair, unequal result which must be corrected.

Total Federal Income Tax

Taxable Income	Current Law	H.R. 3838 As Is	Percent Change
$ 50,000	$ 5,750	$ 7,500	+ 30.4%
100,000	20,750	22,750	+ 9.6%
250,000	82,250	84,250	+ 2.4%
500,000	184,000	180,000	- 2.6%
1,000,000	389,750	360,000	- 7.6%
10,000,000	4,100,000	3,600,000	- 12.2%
100,000,000	41,000,000	36,000,000	- 12.2%

(Chart assumes a progressive corporate investment pattern of 50% of taxable income resulting in an investment tax credit equal to 5% of taxable income).

In summary, progressive small businessmen and women in every walk of American life are seriously damaged by the principles embodied in H.R. 3838. Its reduction of general rates offers far greater benefit to those at the "top" of the scale than to those at the bottom or middle levels. Worse still, its total elimination of the Investment Tax Credit removes a crucial incentive to much needed expansion and growth.

III. Constructive Proposals.

Given the nature of the experiences of so many small businessmen and women, and the ongoing critical role which some form of the Investment Tax Credit plays in their plans for progressive expansion and growth it would seem that the appropriate legislative task is one of modification and refinement, i.e. the protection and enhancement of all beneficial features, with a corresponding reduction or elimination of those less desirable aspects. Too frequently the present debate about investment incentives through the tax code has assumed an unrealistic "all or nothing" quality. Either you are totally for the present ITC or you are totally against it. There is no room for any middle ground. Shaping the debate in this fashion has serioulsy damaged the search for an intelligent compromise. After careful examination of the data and relevant expert interpretation anc analysis, the N.G.A. feels that such a compromise, such a middle ground does exist. It exists in the shape of the concept of a targeted, limited progressive ITC.

While the exact features of such an approach are subject to alteration, its main principles and direction are clear. (1) The imposition of a progressive structure of investment incentives. When translated into law this would mean that as investments increased the taxation credits attached to them would decrease. (2) The substantial reduction or elimination of credit incentivesat the upper end of the scale. (3) A determination of the various investment levels and taxation rate incentives based upon scales which would balance investment stimulus with equity and cost considerations. Such a proposal, if enacted would continue to provide vitally needed economic support for the expansion and growth of progressive small business with none of the waste, ineffiency and unfairness entailed in the present tax credit approach.

As we indicated previously, a variety of specific proposals are available. As models of the concept we have attached several specific appendices which set out possible implementation levels. Careful examination and review of their operations should reveal many of the initial potential benefits of this conceptual approach. (All data contained within these models was prepared by the accounting firm of Friedman and Fuller). See Appendix I, and II and III.

Obviously the model proposals which we have included are not set in stone. They simply represent individual examples of a broader, more fundamental concept. As such a number of their specific features are subject to modification and refinement (For example, the incremental rate differentials or the amount of purchases covered could be altered through differentials or the amount of purchases covered could be altered through different fromulas. Similarly, each example extends the Investment Tax Credit to all investments, no matter how high, at a level of 1%. Cost or effectiveness considerations might lead to an elimination of this provision or to the imposition of a final "cap" at a lower ceiling level). But the concept involved, that of a targeted, limited, cost-effective ITC remains clear. It rests upon four fundamental principles.

First, a targeted, limited ITC of the type described here would retain the empirically verified, beneficial investment incentives for progressive small business found in the present tax code. As we have already noted, while large numbers of the nation's small businesses neither require nor utilize the ITC, for a definite progressive segment it constitutes a vital life support mechanism for further expansion and growth--expansion and growth which are also of major importance to our national economic health. While retaining these elements, the proposal offers absolutely no incentives for abuse of the provisions on the part of the small business community. (To the extent that most small businesses do not now heavily utilize the flat 10% credit they would assuredly not be attracted by the progressive rates found in these proposals).

Second, targeted ITC's of the type described here when combined with various rate reduction proposals achieve a much more fair, much more equitable system than do the current rates of H.R. 3838. Such an emphasis upon fairness must be at the root of any and all consideration of massive tax code changes. Without it, the just principles of genuine tax reform are rapidly transformed into the unfortunate political compromises and influence of old fashioned tax revision. As the numbers which we have enclosed make very clear, our refinements and limitations of the ITC would interact with rate reductions to drastically narrow the range of benefit so that all businesses would be treated fairly and justly.

Third, enactment of an investment system which is heavily progressive in its rate structure (and even potentially capped) eliminates the most costly and most questionable utilization of the ITC under the tax code. Some leading economic authorities have expressed serious reservations about the value and effectiveness of tax investment incentives at the "upper end" of the scale. They argue that the benefits of such provisions for the heavy "smokestack"industries have been neither obvious nor significant and that virtually all examples of abuse and misuse of these provisions occur at these levels. All such problems are eliminated or overwhelmingly reduced under our proposals.

Finally, as we noted in the previous paragraph, an ITC which is heavily progressive in its rate structure virtually eliminates the most costly elements of the present investment tax credit. For example, utilizing the most recent available data from IRS 1982 Corporation Source Book of Income we find that total corporate usage of the Investment Tax Credit in 1982 was $17.3 billion. But of that figure, $15 billion, or approximately 87%, was earned by corporations with assets in excess of $25 million. (And it should be noted that the remaining amount of ITC credit was calculated upon a flat 10% basis,; the progressive feature of the current proposals would reduce revenue loss even further). Quite obviously, a targeted, progressive ITC of the type described herein could be enacted with a minimum cost to the Treasury. Indeed, the undoubted ability of this more sophisticated mechanism to actually work in promoting investment, employment, and growth would make such limited expenditures highly cost-beneficial and cost-effective.

Actual transformation of the limited, targeted Investment Tax Credit concept into legislative reality may well require further modification and alteration. Additional study, expert evaluation, and business reaction can only imporve upon an already sound beginning. But we strongly believe that the idea itself is one whose time has most definately come.

For further information or assistance contact:

The National Grocers Association
Public Affairs Office
Suite 700
1910 K. Street, N.W.
Washington, D.C. 20006
(202) 955-8400

APPENDIX I

Model One

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $1 million of investment purchases will receive an ITC of 10%.

(3) The second $1 million of investment purchases will receive an ITC of 8%.

(4) The third $1 million of investment purchases will receive an ITC of 6%.

(5) The fourth $1 million of investment purchases will receive an ITC of 4%

(6) The fifth $1 million of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES	BREAKDOWN OF PURCHASES						
	50%	1,000,000	2,000,000	3,000,000	4,000,000	5,000,000		TOTAL
		10%	8%	6%	4%	2% —	1%	ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	125,000	0	0	0	0	0	12,500
500,000	250,000	250,000	0	0	0	0	0	25,000
1,000,000	500,000	500,000	0	0	0	0	0	50,000
10,000,000	5,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	0	300,000
100,000,000	50,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	45,000,000	750,000

TAXABLE	CURRENT LAW			PROPOSED LAW			PERCENTAGE	PERCENTAGE
INCOME	TAX	ITC	NET TAX	TAX	ITC	NET TAX	DECREASE	CHANGE W/O ITC
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10%
250,000	94,750	12,500	82,250	84,250	12,500	71,750	-13%	2%
500,000	209,750	25,000	184,750	180,000	25,000	155,000	-16%	-3%
1,000,000	439,750	50,000	389,750	360,000	50,000	310,000	-20%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	300,000	3,300,000	-20%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	750,000	35,250,000	-14%	-12%

APPENDIX II

Model Two

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $500,000 of investment purchases will receive an ITC of 10%.

(3) The second $500,000 of investment purchases will receive an ITC of 8%.

(4) The third $500,000 of investment purchases will receive an ITC of 6%.

(5) The fourth $500,000 of investment purchases will receive an ITC of 4%

(6) The fifth $500,000 of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 500.000 10%	1,000,000 8%	1,500,000 6%	2,000,000 4%	2,500,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	175,000	125,000	0	0	0	0	0	12,500
500,000	250,000	250,000	0	0	0	0	0	25,000
1,000,000	500,000	500,000	0	0	0	0	0	50,000
10.000,000	5,000,000	500,000	500,000	500,000	500,000	500,000	2,500,000	175,000
100,000,000	50,000,000	500,000	500,000	500,000	500,000	500,000	47,500,000	625,000

TAXABLE INCOME	CURRENT LAW			PROPOSED LAW			PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
	TAX	ITC	NET TAX	TAX	ITC	NET TAX		
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10%
250,000	94,750	12,500	82,250	84,250	12,500	71,750	-13%	2%
500,000	209,750	25,000	184,750	180,000	25,000	155,000	-16%	-3%
1,000,000	439,750	50,000	389,750	360,000	50,000	310,000	-20%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	175,000	3,425,000	-16%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	625,000	35,375,000	-14%	-12%

APPENDIX III

Model Three

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $100,000 of investment purchases will receive an ITC of 10%.

(3) The second $100,000 of investment purchases will receive an ITC of 8%.

(4) The third $100,000 of investment purchases will receive an ITC of 6%.

(5) The fourth $100,000 of investment purchases will receive an ITC of 4%

(6) The fifth $100,000 of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 100,000 10%	200,000 8%	300,000 6%	400,000 4%	500,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	100,000	25,000	0	0	0	0	12,000
500,000	250,000	100,000	100,000	50,000	0	0	0	21,000
1,000,000	500,000	100,000	100,000	100,000	100,000	100,000	0	30,000
10,000,000	5,000,000	100,000	100,000	100,000	100,000	100,000	4,500,000	75,000
100,000,000	50,000,000	100,000	100,000	100,000	100,000	100,000	49,500,000	525,000

TAXABLE INCOME	CURRENT LAW TAX	ITC	NET TAX	PROPOSED LAW TAX	ITC	NET TAX	PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10
250,000	94,750	12,500	82,250	84,250	12,000	72,250	-12%	[illegible]
500,000	209,750	25,000	184,750	180,000	21,000	159,000	-14%	-3
1,000,000	439,750	50,000	389,750	360,000	30,000	330,000	-15%	-8
10,000,000	4,600,000	500,000	4,100,000	3,600,000	75,000	3,525,000	-14%	-12
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	525,000	35,475,000	-13%	-12

[1/22/86]

The **Chairman**. John, thank you very much.

Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

Let me commend you for holding these hearings and trying to get a feel for the business people as to what the tax legislation—how it will impact them.

Mr. Smith, I'm wondering how you feel about the 401(k) treatment in the House bill, what effect that will have on your members. Have they given you any indication of what their feelings are?

Mr. **Smith**. Yes, Senator. They would like that portion of the bill modified certainly. It's too low. The cap is, I think, $7,000 and then you deduct an IRA. As I said in my testimony, this country since I have been born—and I'm 61 years old—has never encouraged savings.

Senator **D'Amato**. Sixty-one?

Mr. **Smith**. A young-looking guy, aren't I?

Senator **D'Amato**. You and someone else who celebrated his 39th birthday for the 36th time. [Laughter.]

Mr. **Smith**. We just don't encourage savings, and I think the 401(k) does, and a lot of companies have taken up 401(k)'s. One of our panelists earlier this morning when you were not here talked about that.

Senator **D'Amato**. Let me ask you this: How do you feel about the investment tax credit provisions in this bill?

Mr. **Smith**. The ITC is not a major factor in the wholesale distribution industry. Now wait a minute——

Senator **D'Amato**. The wholesale distribution industry isn't an industry unto itself. If lots of other people who are involved in businesses are going to be adversely affected, don't you think there is going to be some relationship. I'm wondering if we may not be as individuals looking at something a little too parochial as to its exact impact on us.

Let me give you a little piece of news: This bill is so bad, so bad, that your people may not have the volume of work that you have now. You have municipalities that are in the process throughout America of almost shutting down. I'm talking about essential projects. I would probably guess that you have a lot of people doing business directly or indirectly with the tens of thousands of people who are employed, contractors building bridges, sewage treatment plants, parks, airports, you name it, hospitals. You can't sell a municipal bond today. That's one of the things this did.

What I am suggesting is that there are other areas that may not affect you directly in terms of the rates, but if investment tax credits don't affect you, how about some of the people you do business with? You have to factor that into your thinking.

Mr. **Smith**. We have, Senator. Actually the reduced rates will be so dramatic in our industry that they will overcome or offset any loss in investment tax credit.

Senator **D'Amato**. That's fair business——

Mr. **Smith**. Yes.

Senator **D'Amato** [continuing]. But what about the people you're supplying?

Mr. **Smith**. That has no bearing because we supply retailers. We buy from manufacturers.

Senator D'**Amato**. Well, I'm going to tell you—I think that you are going to find that there are some tremendous impacts in this that go beyond. I'm said to people, you know, it's great to say we're going to lower your tax rate—tremendous. We're going to take you from 50 down to 35. That's if you have a job. There are provisions of this bill that go right to whether or not there are going to be jobs in America. It's one thing to promise somebody lower rates, but that's if he has a job.

Mr. Chairman, I'm appreciative of your holding these hearings and also the diversity of opinion.

Mr. Smith, I don't want you to——

The **Chairman**. Before you would leave, if the Senator would yield, I think we have Mr. Smith's answer on the question which I am asking everybody—House bill or no bill? He's got the House bill.

Mr. McCarthy, your organization—House bill or no bill?

Mr. **McCarthy**. Senator, it would be deadly to go through all this time and not simplify this horrible tax system we have, but as you give us that question I would say no bill.

The **Chairman**. No bill? OK, John?

Mr. **Satagaj**. A majority of our group would say no bill.

The **Chairman**. Senator Gorton—I'm sorry, Senator D'Amato, I believe you have a statement for the record.

Senator D'**Amato**. Yes, Mr. Chairman, I have a statement that I would be asked be included in the record as if read in its entirety.

[The prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

FEBRUARY 6, 1986

GOOD MORNING, MR. CHAIRMAN. BEFORE WE PROCEED, I WOULD LIKE TO THANK YOU FOR HOLDING THIS HEARING TODAY. I BELIEVE IT WILL PROVE TO BE OF GREAT IMPORTANCE TO BOTH SMALL BUSINESS OWNERS AND THE CONSUMERS WHOM THEY INTERACT WITH DAILY. IT IS MY SINCERE DESIRE THAT THE SENATE FINANCE COMMITTEE PAY PARTICULAR ATTENTION TO TODAY'S SMALL BUSINESS HEARING TESTIMONY. IT IS THE SMALL BUSINESSES OF AMERICA WHICH WILL BE AFFECTED MOST BY CHANGES IN THE FEDERAL INCOME TAX CODE, AND THIS COMMITTEE HAS THE NECESSARY EXPERTISE TO BEST UNDERSTAND THEIR CONCERNS AND PROBLEMS.

THE HOUSE OF REPRESENTATIVES NARROWLY PASSED H.R. 3838, THE TAX REFORM ACT OF 1985, IN DECEMBER, MAKING SWEEPING CHANGES IN THE TAXATION OF CORPORATIONS, INDIVIDUALS, AND ESTATES AND TRUSTS. THE MOST NOTABLE CHANGES AFFECTING SMALLER BUSINESSES RANGE FROM CHANGES IN ACCELERATED DEPRECIATION SCHEDULES TO THE REDUCTION IN TRAVEL AND ENTERTAINMENT DEDUCTIONS.

I AM IN FAVOR OF TAX REFORM, BUT NOT REFORM WHICH WILL CRIPPLE INCENTIVES TO GROW. I CAN ASSURE YOU I WILL CONTINUE TO FIGHT THOSE PORTIONS OF THIS BILL WHICH I BELIEVE ARE UNFAIR TO SMALL BUSINESS. WHILE MY CONCERNS OVER THIS BILL ARE WIDE AND VARIED, I WOULD LIKE TO CONCENTRATE ON FOUR SPECIFIC ISSUES TODAY WHICH GREATLY AFFECT SMALL BUSINESSES.

THE FIRST ISSUE I WOULD LIKE TO ADDRESS IS THE INVESTMENT TAX CREDIT (ITC). THE ITC WAS CREATED IN 1962 TO STIMULATE THE ECONOMY BY ENCOURAGING INVESTMENTS IN DURABLE ASSETS. BY ENCOURAGING SUCH INVESTMENT, INFLATION IS REDUCED AND NEW JOBS ARE CREATED. THIS PROCESS HAS JUST BEGUN TO TAKE EFFECT AS 1985 AND, SO FAR, 1986 HAVE PROVED TO BE RECORD YEARS FOR INVESTMENT IN NEW PLANTS AND EQUIPMENT. ELIMINATING THE ITC SHOULD NOT BE TAKEN LIGHTLY. WE MUST ASK OURSELF WHETHER THE REVENUES WE WILL GAIN FROM THIS ACTION WILL BE WORTH THE ECONOMIC LOSSES THAT WILL RESULT.

A SECOND INTEREST OF MINE IS PRESERVATION OF GRADUATED CORPORATE INCOME TAX RATES. UNDER CURRENT LAW, A GRADUATED SCHEDULE OF TAX RATES APPLIES TO CORPORATE TAXABLE INCOME. THE HIGHEST OF THE FIVE CORPORATE TAX RATES IS A MARGINAL RATE OF 46 PERCENT, APPLIED TO TAXABLE INCOME ABOVE $100,000.

IN ITS ORIGINAL TAX-REFORM PROPOSAL, THE TREASURY DEPARTMENT SUGGESTED A 33-PERCENT FLAT RATE TAX ON ALL

CORPORATE EARNINGS. SUBSEQUENTLY, THE ADMINISTRATION RESPONDED TO STRONG OBJECTIONS FROM SMALL BUSINESSES AND RESTORED SOME OF THE GRADUATION. THE ADMINISTRATION'S PROPOSAL OFFERED FOUR TAX BRACKETS WITH CORPORATE TAXABLE INCOME BEING TAXED AT THE 33-PERCENT RATE ON INCOME OVER $75,000.

I AM HAPPY TO SAY THAT THE HOUSE TAX-REFORM BILL RETAINS SOME GRADUATION IN CORPORATE TAX RATES. THE BILL SETS A MAXIMUM CORPORATE TAX RATE OF 36 PERCENT ON TAXABLE INCOME IN EXCESS OF $75,000. FOR SMALLER CORPORATIONS, THE RATE STRUCTURE WOULD BE MODIFIED TO RETAIN THE PRESENT RATES OF 15 PERCENT ON TAXABLE INCOME UP TO $25,000. THE RATE ON $25,001 TO $50,000 WOULD BE REDUCED FROM 18 PERCENT TO 15 PERCENT, AND THE RATE ON TAXABLE INCOME BETWEEN $50,001 AND $75,000 WOULD BE REDUCED FROM 30 PERCENT TO 25 PERCENT.

I CAN ASSURE YOU I WILL FIGHT TO RETAIN THIS PROVISION OF THE HOUSE TAX-REFORM BILL IN ANY BILL PRODUCED BY THE SENATE FINANCE COMMITTEE.

MY THIRD CONCERN IS THE EFFECT THE PROPOSED LEGISLATION WILL HAVE ON SECTION 401(K) RETIREMENT PLANS. THE HOUSE BILL PROVIDES FOR A MAXIMUM EMPLOYEE CONTRIBUTION THROUGH SALARY REDUCTION OF $7,000 PER YEAR. THE OVERALL MAXIMUM CONTRIBUTION (BOTH EMPLOYEE AND EMPLOYER) WILL BE REDUCED TO $25,000 PER YEAR OR 25 PERCENT OF THE EMPLOYEE'S

COMPENSATION. ALSO, EACH EMPLOYEE'S INDIVIDUAL RETIREMENT ACCOUNT (IRA) IS TO BE REDUCED BY THE AMOUNT CONTRIBUTED TO HIS OR HER 401(K).

I BELIEVE THIS IS A PRIME EXAMPLE OF THE HOUSE OF REPRESENTATIVES BEING OVERZEALOUS IN ITS SEARCH FOR REVENUE. AT A TIME WHEN PERSONAL SAVINGS RATES ARE LOW, AND CORPORATIONS ARE CUTTING BACK ON BENEFIT PLANS, SUCH RESTRICTIONS ON 401(K) PLANS SEEM INAPPROPRIATE. THE APPEAL OF 401(K)s HAS BEEN STRONG ENOUGH TO INVOLVE AN ESTIMATED 10 MILLION EMPLOYEES. THE ELIMINATION OR RESTRICTION OF THE RETIREMENT PLAN AT THIS STAGE IMPLIES A BREACH OF TRUST INVOLVING NOT ONLY THE EMPLOYEE, BUT ALSO THE EMPLOYER. CHANGING THE RULES ON INDIVIDUALS WHO HAVE BEGUN BUILDING THEIR RETIREMENT PLANS ON 401(K)s IS NOTHING SHORT OF CATACLYSMIC.

MY FINAL TOPIC TODAY IS THE EFFECTIVE DATE FOR TAX REFORM. AT THE END OF THE LAST SESSION OF CONGRESS, SENATE RESOLUTION 477 PASSED THE SENATE BY VOICE VOTE. THIS RESOLUTION WAS BASED ON A SIMILAR RESOLUTION I HAD INTRODUCED EARLIER IN THE YEAR. THE RESOLUTION STATED THAT THE EFFECTIVE DATE OF ANY TAX-REFORM PACKAGE SHOULD BE NO EARLIER THAN JANUARY 1, 1987. IN OTHER WORDS, TAX REFORM SHOULD NOT BE RETROACTIVE. I BELIEVE THAT BY SETTING A PROSPECTIVE DATE OF JANUARY 1, 1987, BUSINESSES HAVE THE OPPORTUNITY OF OPERATING

IN A STABLE MARKET, UNDER CURRENT TAX LAW, WITHOUT THE FEAR OF RETROACTIVE TAXATION,.

RETROACTIVE TAX REFORM IS UNFAIR TO BOTH THE INDIVIDUAL AND THE CORPORATION. THIS TYPE OF TAXATION CHANGES THE RULES IN THE MIDDLE OF THE GAME. IT IS MY HOPE THAT THE FINANCE COMMITTEE, WHEN IT BEGINS MARK-UP OF THE TAX-REFORM BILL, WILL RESPECT THE WISHES OF THE SENATE AND SET A PROSPECTIVE EFFECTIVE DATE FOR THE TAX-REFORM PACKAGE.

WHILE I REALIZE THERE ARE MANY OTHER SPECIFIC ISSUES AFFECTING SMALL BUSINESSES, I BELIEVE THE ISSUE OF EFFECTIVE DATES IS AN ISSUE WHICH MUST BE TAKEN CARE OF BEFORE WE PROCEED ANY FURTHER WITH THIS TAX-REFORM PROPOSAL. BUSINESSES MUST KNOW IF THEY CAN PROCEED TO DO BUSINESS IN A NORMAL FASHION.

THANK YOU, MR. CHAIRMAN.

Senator D'AMATO. Again, I want to commend you for calling these hearings and the witnesses.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman.

I would associate myself with many of the remarks, particularly some thoughts my colleague from New York just made. I would also join in telling you that I think it's quite important that members of the Senate who are not members of the Finance Committee have an opportunity to listen to the constituencies which they represent and which they reflect in connection with the impact of the House so-called tax reform bill or what might emerge from the Senate Finance Committee.

Senator D'Amato and I have both been attending meetings of the Senate Banking Committee dealing with businesses within its jurisdiction on that subject. In one very distinct respect, Mr. Chairman, you've done a considerably better job. You at least have a debate. In 3 days there hasn't been a single witness before the Banking Committee who has been willing to say a good word about the proposal which passed the House of Representatives.

I am happy to have people here who are at least weighing the relative merits and the demerits of the proposal which passed the House.

I fall on the side of the two last speakers who say if they are faced with the House bill unchanged and doing nothing at all, they would prefer to do nothing at all and start over. I share that view.

I do believe it possible to reform our tax system in a way to make it more fair and less complicated and at the same time provide incentives that build the economy rather than tear it down, that save rather than consume. But I think that the House bill has fallen very, very far from that set of goals.

At this point in the process I do want to thank these and the other witnesses.

The CHAIRMAN. Thank you very much, Senator Gorton.

I thank the panel.

At this point in the hearing, with five witnesses left, the score is 3 to 3 on House bill or no bill. [Laughter.]

Mr. SMITH. I wish I had more time. [Laughter.]

The Chairman. Our next two witnesses are Walter Stults of the National Association of Small Business Investment Companies and Burton McMurtry of the National Venture Capital Association.

Walter has had a death in his family, so Peter McNeish will replace him.

I might add as we discuss this area of venture capital, I just want to state how important capital gains are to new business formations and the growth of emerging companies. The committee, as you know, has continually fought to maintain a significant differential in low capital gains rates. Indeed, I think one of the most successful efforts of the Small Business Administration has been its efforts in venture capital through the various mediums.

The first witness, then, will be Pete McNeish. Pete, why don't you begin?

STATEMENT OF PETER McNEISH, VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, WASHINGTON, DC

Mr. McNeish. I'll get our vote on the record right away. Without question, we would say no bill.

The House-passed tax legislation would absolutely devastate the SBIC industry and cripple thousands of businesses, growth firms for the most part, which the Nation depends on for job creation, technology, innovations, competition, and export trade.

It's clear—by the record and the success stories we put on the record before this committee in past testimony—that for SBIC's and the success stories they have been able to generate, as for all other investors and our brethren in the general venture capital industry, the level of Federal taxation of long-term capital gains is by far, without question, the most important provision of the Internal Revenue Code.

The evidence is quite clear that a meaningful differential between the tax rates on ordinary income and those on long-term capital gains guarantees the essential flow of equity capital to entrepreneurs.

This past year SBIC's made over 3,000 investments in a total amount of well over half a billion dollars in small growth firms, a large percentage of those firms being new starts or businesses less than 1 year old.

We feel very strongly that the capital gains changes contained in the House-passed bill would throw that kind of record out the window, would destroy in large part the SBIC industry, and would have negative ramifications for the venture capital industry generally.

The historical record is quite clear as well. The near extinction of capital venture sources between 1969 and 1978 had shown the absurdity of removing the incentives for institutions and individuals to invest in growth business. We were heartened when Treasury II proposed a reduction in individual and corporate capital gains rates, with some supporting documentation. In fact, reductions in those rates have generated increased revenues historically.

The impact on the venture capital industry of H.R. 3838, as I said, would devastate the SBIC industry because 90 percent of our companies are in corporate form, and those corporate SBIC's, hold over 90 percent of the assets of the industry.

Furthermore, it would have several negative, secondary effects, not directly related to the SBIC's, but certainly bearing on SBIC investments. It would affect in large part—and my colleague here today will speak more directly to that—the private venture firms. As Stan Pratt has indicated in his Venture Capital Journal—Stan is editor of that publication—some 41 percent of all the dollars in the organized venture capital industry are either held by corporate venture capital firms or invested by taxpaying corporations.

Insurance companies, for example, have already expressed to a number of our members their deep concern that they may have to pull out of the venture capital field if, in fact, the tax bill passed by the House were enacted into law.

A third effect—somewhat secondary but very directly related to investments in growth firms—H.R. 3838 would kill incentives for other corporations to invest in venture situations. Nonfinancial corporations have become increasingly important players in the venture capital arena, particularly in second, third, and fourth round investments. We think that would dry up as well with the corporate capital gains differential eliminated and the capital gains rate made the same as corporate rates.

Our conclusion on H.R. 3838 is relatively simple and based on historical records, and our recommendation is twofold: No. 1, we are encouraged by that portion of Treasury II that recommended dropping the individual capital gains rate to 17.5 percent and maintaining a meaningful differential between that and the individual ordinary income tax rates. We differ, however, in treatment under Treasury II—certainly under H.R. 3838—of corporate cap gains rates. We would argue strongly for parity between the rates on corporate cap gains and individual cap gains.

We have, Mr. Chairman, several other items, both in Walter's written testimony and some documents we'll submit for the record a little later. But, again, to repeat, we would prefer no bill at the present time or certainly a modification to retain the corporate cap gains differential and to bring parity to corporate capital gains taxes in any consideration of tax reform by the Senate.

We appreciate the opportunity to be heard and the fact that you're bringing small business concerns over taxation to the attention of the Senate. Thank you, Senator.

[The prepared statement of Mr. Stults and additional material to be supplied by the National Association of Small Business Investment Companies follows:]

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
1156 15TH STREET, NW • SUITE 1101 • TELEPHONE (202) 833-8230
WASHINGTON, DC 20005

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WALTER B. STULTS
EXECUTIVE VICE PRESIDENT
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*EXECUTIVE COMMITTEE

February 6, 1986

STATEMENT OF

WALTER B. STULTS

Before the

SENATE SMALL BUSINESS COMMITTEE

PENDING TAX PROPOSALS

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Walter B. Stults, President of the National Association of Small Business Investment Companies (NASBIC) which represents the overwhelming majority of all licensed small business investment companies (SBICs) and minority enterprise SBICs (MESBICs). Thank you for giving our Association this opportunity to express its views on the various tax "reform" proposals which are being considered by the Congress and the Administration.

The House-passed tax legislation would devastate our industry and would cripple hundreds of thousands of growth businesses upon which the Nation is so heavily dependent for job creation, technological innovation, competition, and export trade. My statement will cover two major areas: (1) the tax treatment of long-term capital gains and (2) other ramifications of H.R. 3838 on capital formation and business growth.

The Critical Importance of Capital Gains Tax Rates

For SBICs, as for all other investors in American business, the level of Federal taxation of long-term capital gains is by far the most important provision in the Internal Revenue Code. The evidence is irrefutable: a meaningful differential between tax rates on ordinary income and those on long-term capital gains guarantees the essential flow of equity capital to entrepreneurs trying to start new businesses or striving to expand their existing operations.

The "Laffer Curve" has been ridiculed by many. I can't vouch for its overall soundness, but I can surely speak for the venture capital industry when I say that the reductions of taxes on long-term capital gains in 1978 produced more revenue for the Federal Government. The Treasury Department at the time took its traditional position and told Congress that the cut in such taxes would "cost" the Nation billion of dollars in tax revenues. That's what the so-called experts said, but what actually happened? Each year since 1978, the Treasury has taken in more revenues from long-term capital gains -- in the face of a major slash in the tax rate on such income.

Remember, I am referring solely to the direct, or the "static" result of the cut: RATES DOWN, REVENUES UP. I am not taking into account the "dynamic" impact of the reduction; that is, additional taxes paid by the businesses which received venture capital from our industry and equity capital from other investors.

NASBIC members were dumbfounded at Treasury I's frontal attack on the capital gains tax differential. We believed that the near extinction of venture capital sources between 1969 and 1978 had shown the absurdity of removing incentives for institutions and individuals to invest in growth businesses. We were heartened when wiser counsel prevailed and Treasury II advocated the continued capital gains tax differential. Then came H.R. 3838, however, and the House of Representatives voted to raise capital gains tax rates for individuals and to eliminate the differential completely for corporate investors.

1. The Impact of H.R 3838 on Corporate Venture Capital

Stated as baldly as possible: the enactment of the capital gains provision of H.R. 3838 would devastate the SBIC industry. Ninety percent of all SBICs operate in corporate form; those licensees hold more than 90% of all the capital committed to the SBIC industry. The SBIC industry invested well over one-half a billion dollars in 1985 ($542-million) in 3,093 small firms. The House-passed bill would kiss off that remarkable record.

Furthermore, H.R. 3838 would kill any incentive for other corporations to invest in venture situations. Non-financial corporations have become increasingly important players in the venture capital arena, often providing the larger sums necessary when a growth business requires its third or fourth round of venture capital.

Even Treasury II would have been a disaster for venture capital operations. That proposal called for the corporate capital gains tax rate to remain at 28%, while cutting the top rate on ordinary corporate income to 33%. NASBIC strongly protested that initiative, because it is clear that few corporations would invest their funds in high-risk, long-term investments when the tax rate differential between ordinary and long-term capital gains income was only 5%.

So -- Treasury II was a disaster for corporate SBICs and corporate investors, but H.R. 3838 truly brings us to Armageddon. The flow of venture capital would be reduced significantly, because Stanley Pratt, editor of Venture Capital Journal, has calculated that 41% of all the dollars in the venture capital industry is either held by corporate venture capital firms (including SBICs) or invested by tax-paying corporations.

2. The Impact of H.R. 3838 on Non-Corporate Venture Capital

The Ways and Means Committee and the House retained a capital gains tax rate differential for individual taxpayers, but substantially reduced the attractiveness of venture capital investing. Under present law, non-corporate venture capitalists (individuals and partnerships) pay a maximum tax of 20% on their long-term capital gains -- in contrast to the top tax rate of 50% for ordinary income. That differential has proven to be sufficient to brings tens of billions of dollars into the organized venture capital industry over the past seven years.

H.R. 3838, on the other hand, would significantly pare that differential, taking it down from the present 30% to 16%. The bill achieves that lamentable result by cutting the top rate on ordinary income to 38%, while increasing the maximum rate on long-term capital gains to 22%. It is far from clear that H.R. 3838 leaves enough of an advantage to induce taxpayers to invest their dollars in high-risk, long-term, illiquid investments where even the "winners" may be illusory, because of inflation.

3. The Impact of H.R. 3838 on Treasury Revenues

I have already testified that past reductions in capital gains tax rates have brought more dollars to Uncle Sam. That is proven; it's documented. Nonetheless, the Government's tax analysts still maintain that eliminating the capital gains tax differential will produce more revenue. I have not been able to learn the exact figures they whispered into the ears of the Ways and Means Committee, but I understand they claimed the added revenues would be substantial. That thesis was proven false in 1969, the last time Congress increased capital gains taxes -- and it will prove to be false again if tried this year.

It's unanimously agreed that the Federal Government needs additional tax revenues, not less. History has demonstrated that higher capital gains taxes will decrease revenues, while reasonable cuts in those tax rates will bring in more dollars.

4 NASBIC's Recommendation on Capital Gains Taxes

Treasury II was correct in proposing that a meaningful differential be preserved by calling for a maximum rate of 17.5% on long-term capital gains earned by individuals. NASBIC strongly supports that change. We differ from Treasury II, however, when we urge the Senate and the Congress to bring the capital gains tax rates for individuals and corporations back into parity by cutting the rate on corporate capital gains to the same 17.5%. Historically, the two types of taxpayers had faced the same level of taxes on capital gains, so our proposal is not revolutionary in any sense.

Other Features of Importance to Small Business

In essence, NASBIC finds that H.R. 3838 is an anti-business, anti-investment, anti-capital formation measure. It will stunt the growth of new and small businesses. Its call for a cut in the maximum tax rate for corporations and individuals is an enticing siren's call, but we must look beyond that soothing music. Let me give you several examples:

Depreciation: H.R. 3838 basically goes back to the old, discredited ADR system of writing off investments in plant and equipment. Small business organizations were unanimous in screaming for the end of that cumbersome procedure which few small firms were able to utilize, although their larger competitors could do so. The simplified depreciation methods adopted in 1981 are extremely beneficial to growth businesses, permitting them to plow back more of their earnings into more jobs and more and better equipment. Can this change be explained in terms of "fairness", "simplicity", or "economic growth"? I believe the evidence is clear: it fails on all three criteria.

Investment Tax Credit: Here is another mechanism which encourages firms to grow and to plow back more of their cash flow and to expand their productive capacity. Perhaps, it's fruitless even to mention this subject, since every "expert" seems to agree that the ITC is doomed. I urge your Committee to reject that common wisdom and weigh the interim costs and the long-range gains attributable to the investment tax credit. Other witnesses will, I am sure, deal with this important subject in more detail.

Graduated Corporate Rates: At least, H.R. 3838 does not call for a flat rate on all corporate earnings from the first dollar. That's something to be grateful for, perhaps, but the bill does reduce greatly the advantages of graduation as it exists in current law. The rates are significantly lowered for the most profitable -- but remain about the same for the smallest, or the least profitable. Furthermore, the recapture provision in H.R. 3838 means that the types of growth businesses in which we invest will soon lose 100% of the graduation -- and well before they are ready or able to compete with giant corporations -- whose rates will have been cut from 46% to 38%. We believe that graduation should be extended to help meet the needs of such growth firms.

Conclusion

Over the years, your Committee has contributed greatly to the vigor of the independent sector of the American economy by working closely with the tax-writing committees of the Congress. Hearings such as this, official reports on the tax needs of small business, and the valuable cross-membership between this Committee and the Finance Committee have assured that the special needs of new and small businesses have been addressed during ther debates on tax policy.

The 1985-1986 deliberations on comprehensive tax reform have differed little from the past. The sloganeering has been inspired -- who could argue against "fairness", "simplicity", or "economic growth"? But the reality has changed not a whit -- the most politically powerful interests have saved their tax advantages, while those who are less organized or less numerous end up bearing the brunt of so-called "reform". It has always been difficult for the millions of small businesses -- and their representatives -- to get together and agree on a coordinated program or on an effective political strategy. The small business community is incredibly diverse; it's impossible to determine who is the goose and who the gander when the sauce is being divvied up.

For all these reasons, we rely on your Committee to guarantee that the interests of small business are fairly represented in the tax policy debate. NASBIC, its members and its staff, remain at your service. Thank you.

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
1156 15TH STREET, NW • SUITE 1101 • TELEPHONE (202) 833-8230
WASHINGTON, DC 20005

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*EXECUTIVE COMMITTEE

March 3, 1986

The Honorable Lowell Weicker, Jr.
Chairman
Senate Small Business Committee
SR-428A, Russell Senate Office Building
Washington, D.C. 20510

Re: Deductibility of Interest

Dear Mr. Chairman:

During his testimony before your Committee during its tax hearings, Peter McNeish promised to submit additional material concerning the impact of pending tax "reform" measures on small business.

Attached is a copy of a letter I wrote to Senator Sasser who is a member of both the Small Business and Finance Committees. I addressed identical letters to Senators Baucus and Boren. The letter tells of our fears about a proposed limitation on the ability of firms to deduct their interest payments as business expenses.

We hope that the Small Business Committee will focus its attention on this potential threat, as well as the others covered in our earlier testimony, when it considers its recommendations on the comprehensive revision of the Internal Revenue Code.

Thank you for your continuing efforts on behalf of a vigorous, growing small business community

Sincerely,
Walter
Walter B. Stults
President

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NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
1156 15TH STREET NW • SUITE 1101 • TELEPHONE (202) 833-8230
WASHINGTON, DC 20005

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ROBERT H. WELLBORN
REPUBLIC VENTURE GROUP INC
DALLAS TX

March 3, 1986

The Honorable James R. Sasser
SR-298, Russell Senate Office Building
Washington, D.C. 20510

RE: Deductibility of Interest

Dear Senator Sasser:

The officers and staff of NASBIC are deeply concerned about a possible change in the Internal Revenue Code which would restrict the ability of businesses to deduct all of their interest payments as business expenses. We are not certain of the status of this proposal, but it has been reported recently in press accounts of the Finance Committee's deliberations.

Such a change in the tax law would be a KILLER for smaller firms, particularly young ones and those which are growing. These sorts of businesses are almost wholly dependent upon debt financing for their birth and growth -- and they are seldom able to obtain equity funding.

Once again, a legitimate Congressional concern about the financial practices of major corporations poses a tremendous threat to the existence of smaller companies. In this case, Paul Volcker and others feel that big businesses buy back their stock and borrow additional billions of dollars because of the tax treatment of interest payments. That may well be true, but don't kill the small, growth firms which must depend upon debt to "solve" the problem.

Let me give you an example of how tax laws and regulations wittingly discriminate horribly against smaller firms. In 1969, Congress passed a law directing the Treasury Department to define "debt" and "equity" for tax purposes. Treasury has been trying to accomplish that task for the past 17 years. Every one of its proposed regulations under Section 385 of the

Code has utilized the debt-equity ratios of the Fortune 500 corporations as a base. NASBIC and all the other small business organizations have been forced to attack each of the proposals, because Treasury and IRS failed to understand the difference between large and small businesses in capital-raising ability.

We plead with you to combine your role on the Small Business Committee and your place on the Finance Committee to focus the latter's attention on this crucial issue.

Naturally, NASBIC stands ready to provide you and your staff any further information. We appreciate your continuing efforts on behalf of small business.

Sincerely,

Walter B. Stults
President

The CHAIRMAN. Thank you very much.

Our next witness is Mr. Burton McMurtry, partner of Technology Venture Investors, representing the National Venture Capital Association.

STATEMENT OF BURTON J. McMURTRY, GENERAL PARTNER, TECHNOLOGY VENTURE INVESTORS, MENLO PARK, CA; REPRESENTING THE NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. McMURTRY. Thank you. It's a pleasure to be here.

I want to support a number of the comments that have already been made by Peter. If we had a choice of the House bill or no bill, we would have to choose no bill, although we would hope that some changes can be made in the bill that will make it more attractive.

The Treasury II proposals on capital gains tax rates look attractive for individuals but in our view do not go far enough for corporations. We, too, think it is rational to seek parity between corporate and individual capital gains tax rates and that the House bill, which essentially eliminated any differential between capital gains tax rates for corporations compared to that on ordinary income, really is inappropriate.

I wish I knew sort of the level of differential that is really critical to this whole process. I wish I knew the level of absolute capital gains tax rate that was really critical to this process. I'm afraid I don't, and I'm unhappy that I don't but I feel obligated to admit to you that I do not have the formula on capital gains tax rate.

What I do know from my experience in the venture business from 1969 is that during most of the 1970's small businesses and growth businesses in this country lived in really a capital starved climate. That did not change until the capital gains tax reductions of 1978.

I am not in the camp that says capital gains tax reductions drove the entire economy. I think that's a rather incomplete statement, but I am very much in the camp that says they were extremely important. I saw them at work in our own companies.

I think the idea of lowering the capital gains tax rate and of having a significant differential between the tax rates on ordinary income and capital gains has been very important in providing this tremendous flow of capital for young companies and for growth companies in general. I would hope that we can maintain that.

I think the move in the House bill, for example, to change the maximum rate on capital gains from 20 to 22 percent is something that I find very offensive, but I also find it difficult to be absolute about that. I do not have the formula—you know, that 22 percent is sinful and 20 percent is OK. I can't say that. What I can say is that I think investors and entrepreneurs respond very much to signals, and the signals in recent years have been we are reducing rates on capital gains; we are encouraging investment in long-term assets; and I would like to see us continue that kind of a policy.

There is one other area that I would like to mention and leave more time for questions. The one part of the law that has been very important for young companies, and in fact in most of the companies that we have invested every employee has an equity position in the company, either through the ability to purchase stock directly or through an employee stock purchase plan or an incentive stock option program.

Some changes were made in the incentive stock option program a few years ago which make it less attractive. I have referred to those in my statement, having to do with sequential exercise, and in particular having to do with the spread between exercise price and fair market price being a preference item.

We would certainly like to see some modifications made to the incentive stock option area. We have a very peculiar situation now in that, for example, under the House bill you might have a situation in which someone who exercise a stock option is subject to a preference tax on that exercise at the 25-percent level, does not get a step-up in basis, sells the stock later for gain, and is at that time subject to a 25-percent tax. So, you effectively have a 47-percent tax on entrepreneuring built into the incentive stock option program, and I think that is not one that was intended. This is not something that is of benefit, direct benefit, to the investors. It is of direct benefit to entrepreneurs and something that I think we should try to address.

Finally, I would just encourage that this committee and the Senate hopefully will pay close attention to one backdoor way of increasing capital gains taxes; that is, to have an alternative minimum tax which sweeps capital gains in with it. You might have a nominal 17.5-percent capital gains tax rate, but if you have an alternative minimum tax that is structured as earlier proposals were structured, you might in fact have a net capital gains tax rate equal to that alternative minimum tax rate. That, of couse, was changed in the House bill. I think it is one of the features that is important in what was done in the House bill to provide that the maximum tax on capital gains would not be higher than a specified level.

Without taking more of your time, I would like to stop and ask for questions.

[The prepared statement of Mr. McMurtry follows:]

PREPARED STATEMENT OF BURTON J. MCMURTRY, GENERAL PARTNER, TECHNOLOGY VENTURE INVESTORS, MENLO PARK, CA, PRESIDENT-ELECT AND DIRECTOR, NATIONAL VENTURE CAPITAL ASSOCIATION

I am Burton J. McMurtry, General Partner of Technology Venture Investors of Menlo Park, California, and President-Elect and Director of the National Venture Capital Association (NVCA), which represents over 200 member firms, who have over $12 billion under management. On behalf of NVCA and the industry, I appreciate the opportunity to testify concerning the Administration's tax proposal and the House bill and their effect on the availability of capital for growth businesses.

The capital gains tax rate and the differential between tax rates on capital gains and other income have a large influence on the availability of capital for small, growing businesses. Please see Appendix A for portions of earlier NVCA testimony on this topic before the Senate Finance Committee.

The primary tax policy goals of the NVCA are to:

1. maintain a significant differential between the tax on capital gains and that on other income;
2. lower the present rate of tax on capital gains; and
3. allow an alternative minimum tax on capital gains preference income that is no higher than the maximum individual capital gains rate.

The chart below summarizes individual tax rates under current law, the Administration's plan, and the House bill.

INDIVIDUAL

	Current Law	Administration's Proposal (May 1985)	House Bill (Dec. 1985)
Maximum Income Rate %	50	35	38
Maximum Capital Gains Rate %	20	17 1/2	22
Differential %	30	17 1/2	16

We strongly support the Administration's proposal for a 17 1/2 percent maximum rate of tax on capital gains. But even at that level the differential has shrunk by half as it would drop to 17 1/2 percent from 30 percent under current law.

It is imperative that the Congress continue to maintain an environment that encourages investment. To that end, a modest reduction to 17 1/2 percent from 20 percent under current law would send an important signal that risk investment remains a top priority. This reduction is particularly important since both the Administration's proposal and the House bill provide much larger reductions in the maximum tax rate on other income, e.g., from 50 percent to 35 percent under the Administration's proposal and to 38 percent under the House bill.

The following chart summarizes corporate tax rates under current law, the Administration's plan and the House bill.

CORPORATE

	Current Law	Administration's Proposal (May 1985)	House Bill (Dec. 1985)
Maximum Income Rate %	46	33	36
Maximum Capital Gains Rate %	28	28	36
Differential %	18	5	0

For corporations, as opposed to individuals, the differential between the proposed maximum tax rate on capital gains and that on other income has been reduced from 18 percent under current law to 5 percent under the Administration's proposal and to zero under the House bill. Since more than 40 percent of the commitments to venture capital come from corporate sources and since many venture capital companies are themselves corporations, the House bill's treatment of corporate capital gains would lead to an extremely serious impedment to the availability of capital for investment in small businesses and in growth companies in general.

We thus encourage you to restore a corporate capital gains rate that is on par with the individual capital gains rate which we hope will be set at 17 1/2 percent. The need for a differential and for a low maximum rate seems to us to apply to both individual rates and corporate rates.

Another issue of paramount importance to both the entrepreneurial and venture capital communities is the alternative minimum tax rate. The House carved out an exception for capital gains by stipulating that the alternative minimum tax rate for capital gains preference income can be no higher than the maximum individual capital gains rate. Translated this means 22 percent for both rates in the House bill. As I mentioned earlier, we hope the Senate will peg both rates at 17 1/2 percent in its bill.

Before closing, Mr. Chairman, I would like to take this opportunity to urge the Senate to consider incorporating the features of a capital gains related measure introduced in 1984 by Senators Packwood and Bentsen which would have modified the incentive stock option (ISO) provision in three ways:

1. The spread between the exercise price and the fair market value would no longer be a preference item when computing the minimum tax.
2. The sequential exercising rule would be repealed.
3. The rule limiting the granting of no more than $100,000 in options per year would be changed so no more than $100,000 could be exercised in any one year.

The text of the bill and the introductory statements are attached as Appendix B.

ISOs are an important tool used by young, innovative firms to reward dedicated, but usually underpaid employees during the firm's formative years. ISOs are also a critical factor in attracting experienced, senior management needed to assure the continued high growth of these companies.

This proposal could be incorporated as part of the tax reform package at little or no cost, Mr. Chairman. In fact,,experts tell us that Treasury would actually make money by its adoption.

Thank you, Mr. Chairman, for the opportunity to appear before the Committee.

Appendix A

Portion of testimony by Don E. Ackerman before the Committee on Finance, June 26, 1985

Since the Steiger bill of 1978 and the further reduction of capital gains rates in 1981, entrepreneurial activity, risk investment and the infusion of equity capital into job creating growth companies, has provided a healthy stimulus to our economy and the development of new technologies in our country.

It is a fact that:

- Growth companies create jobs, improve productivity and increase tax revenue.
- Equity capital is the lifeblood of growth companies.
- Equity capital is highly sensitive to the capital gains rate and the differential between the rate of tax on capital gains and that on other investment income.

Therefore, the Administration capital gains proposal will:

- Increase the rate of job creation.
- Increase the growth in tax collections from payroll, social security and corporate income.
- Improve the deficit in the balance of payments.
- Enhance the rate of innovation in the economy.

We are submitting data with this testimony that supports these statements. The availability of risk capital is dramatically affected by Federal tax policy. The facts show there is a direct relationship between investments by venture capital firms in portfolio companies and the maximum rates on long-term capital gains

There is significant historical evidence of this relationship. From the Tax Reform Act of 1969 through the Tax Reform Act of 1976, Congress raised the maximum capital gains tax from 25 to 49 percent. The effect on the venture capital industry was profound. Disbursements to entrepreneurial companies by venture capital firms dropped from $450 million in 1969, down to $250 million in 1975 -- a 45 percent decrease. Even more serious, new private capital committed to venture firms dropped from $171 million in 1969 to a mere $10 million six years later, in 1975. (see Table 1.)

The high capital gains tax rates beginning in 1970 disrupted the capital markets and dried up the flow of funds into both over the counter markets and venture capital firms. Price earnings ratios of OTC growth companies were depressed during the period of high capital gains taxes which both raised the cost of capital to growth companies and lowered the rate of return to risk investors on successful investments. (see Table 2)

It was not until 1978, when the rate of tax on capital gains was reduced to 28 percent, that risk capital once again began to flow into the marketplace. Just a year before the 1978 act, only $39 million in private capital had been committed to venture capital firms. In 1978, with the enactment of the lowered rate, $570 million was committed, and disbursements to portfolio companies rose over 30 percent. The continuation of this lower capital gains tax rate enabled the industry to flourish and fund thousands of entrepreneurs. By 1983, some $4.5 billion in private capital was committed to venture capital firms (see Table 3).

The revival of the over the counter market and initial public offerings also coincided with the capital gains reductions (see Table 4). It is important to recognize the critical linkage between healthy public capital markets and the availability of venture capital funds. The OTC market provides the larger amounts of capital required by growth companies after their venture capital funded start up period. The OTC market also provides the liquidity and pricing mechanism that permits investors to realize gains on venture investments. The level of venture investing declines significantly if there is no availability of public market growth capital or opportunity for liquidity and acceptable price levels.

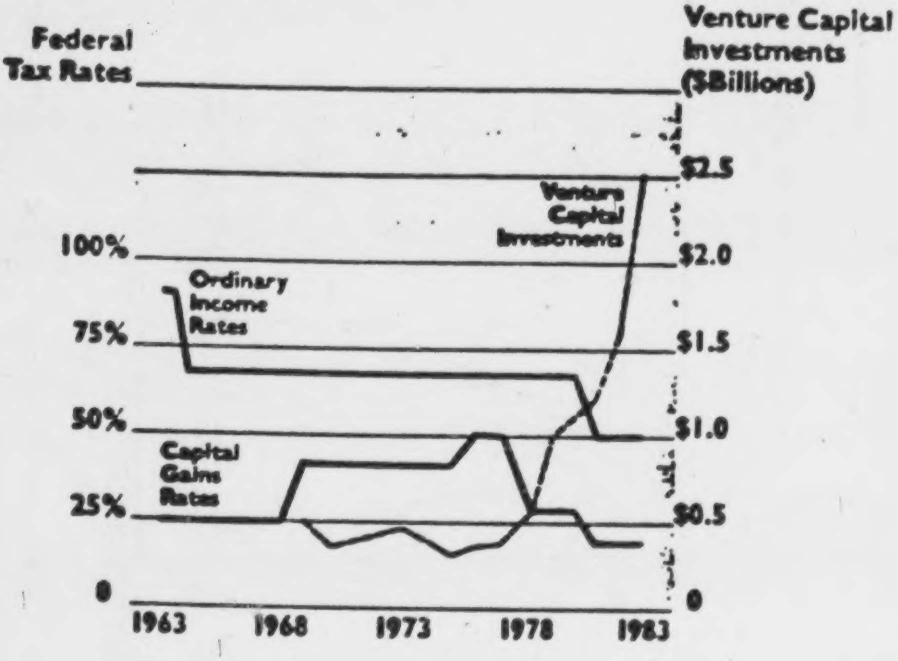
The capital gains differential has raised the after tax rate of return for risk investing and has created healty equity markets. The result is that a wide range of investors have committed to both venture and OTC investments. Since on any given investment tax exempt entities receive a higher after tax rate of return than tax paying entities, significant investments have been made in venture capital funds by tax exempt sources.

It is clear that lower capital gains tax rates will result in stronger economic growth, more tax revenues, and an acceleration of the rate of innovation. Low capital gains rates have had a dramatic impact on the growth of innovative companies. We offer the example of the electronics industry. From 1974 through 1977, the industry grew slowly, laboring under effective maximum capital gains rate of 49 percent. In 1978, when that rate dropped to 28 percent, the annual payroll jumped from $19.7 billion to $24.1 billion. That added an estimated $600 million in personal taxes paid -- in just that year. The industry continued to expand, receiving another boost in 1981 when the effective rate was dropped again to 20 percent. By 1983, payroll was estimated at $49.8 billion -- an increase of over 100 percent from five years earlier. Personal taxes paid increased accordingly to $7.5 billion (see Table 5).

TABLE 1

Influence of Tax Rates on Investments

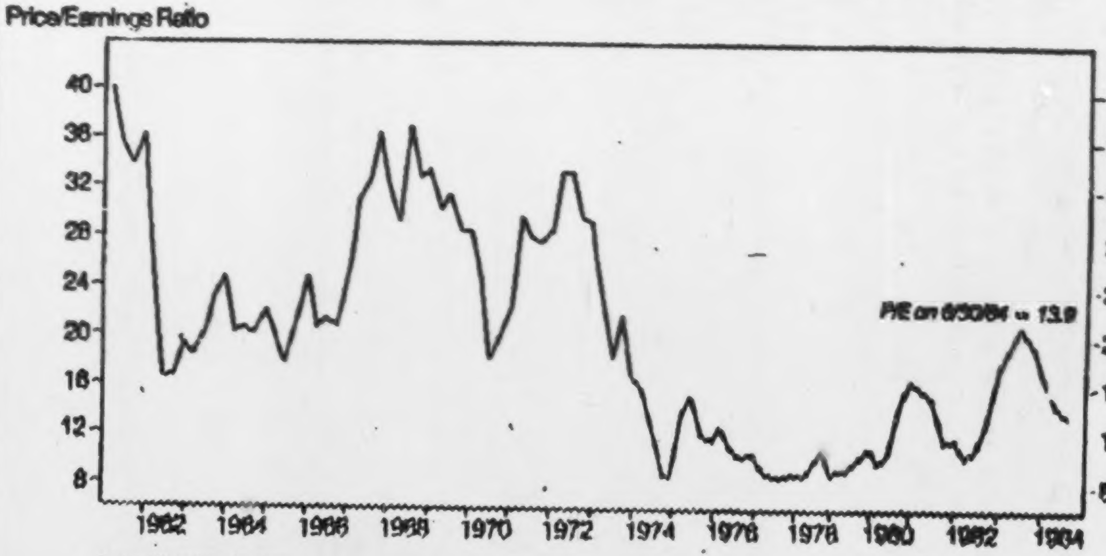
Relationship between direct investments by venture capital firms in portfolio companies and the maximum rates on long-term capital gains and ordinary income



SOURCE Syntrex Incorporated and Capital Publishing Company, 1983

TABLE 2

New Horizons Fund Price/Earnings Ratio



Source: T. Rowe Price Associates
Note: This chart is intended to track the average price/earnings ratio of New Horizons portfolio companies, based on earnings per share estimates issued by the Fund's investment adviser for 12 months ahead from each quarter end.

TABLE 3

Venture Capital Industry

Estimated Venture Capital

($ Millions)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Size of Total Pool
1983	$ 4,500	$ 2,800	$11,500
1982	1,700	1,800	7,600
1981	1,300	1,400	5,800
1980	900	1,100	4,500
1979	319	1,000	3,800
1978	570	550	3,500
Capital Gains Tax Decrease			
1977	39	400	2,500-3,000
1976	50	300	—
1975	10	250	—
1974	57	350	—
1973	56	450	—
1972	62	425	—
1971	95	410	—
1970	97	350	—
Capital Gains Tax Increase			
1969	171	450	2,500-3,000

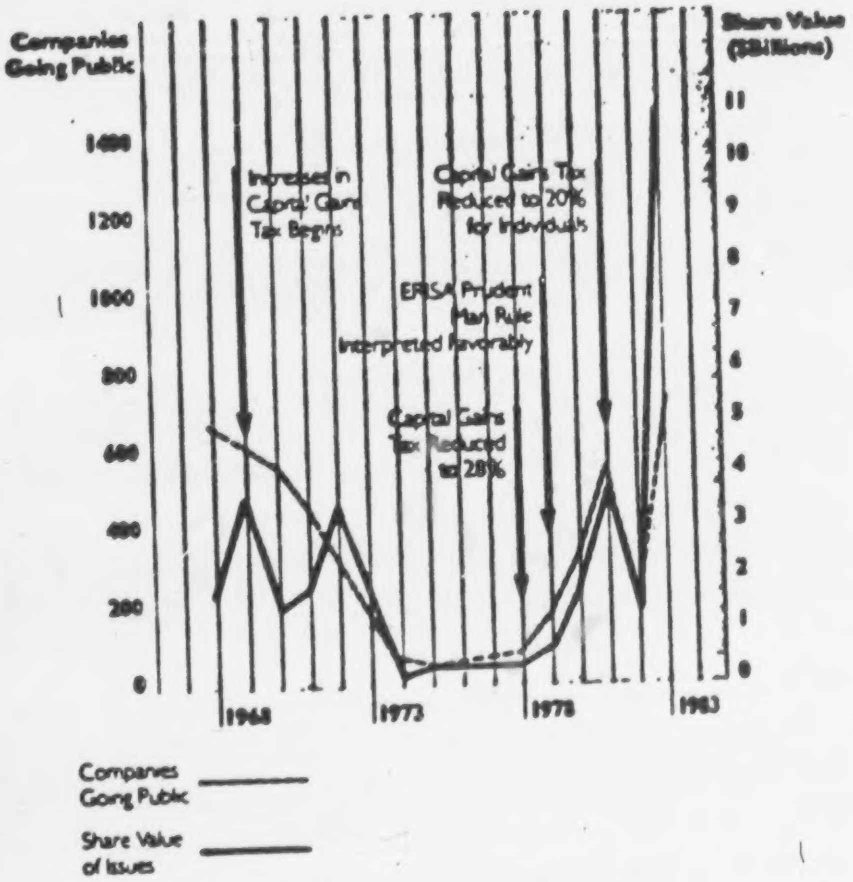
SOURCE: *Venture Economics*, August 1984

TABLE 43

Policy and Rules Changes

Effect on Flow of Public Offerings

(Current Dollars)



SOURCE: (For Figures Only) *Investment Dealers' Digest*, 1/17/84

TABLE 5

SIZE OF U.S. ELECTRONICS INDUSTRIES, 1974-1983

Years	Number Employees	Annual Payroll (billions)	Estimated Personal Taxes Paid** (billions)	Capital Gains Effective Maximum Tax Rate
1974	1,440,000	$ 15.8	$ 2.4	49%
1975	1,300,000	15.9	2.4	49
1976	1,300,000	17.5	2.6	49
1977	1,430,000	19.7	3.0	49
1978	1,570,000	24.1	3.6	28
1979	1,790,000	29.3	4.4	28
1980	1,960,000	35.1	5.3	28
1981	1,970,000	39.8	6.0	20
1982	2,070,000	43.5*	6.5	20
1983	2,280,000	49.8*	7.5	20

* Data for 1974-1981 are AEA estimates based on data published in County Business Patterns. Data for 1982 and 1983 are AEA estimates based on data supplied to AEA by the Bureau of Labor Statistics. Comparable data is not available for years prior to 1974. The 1983 employment total includes selected service categories not included in prior years.

** Assumes average effective personal tax rate of 15%.

STATEMENTS ON INTRODUCED BILLS AND JOINT RESOLUTIONS

By Mr. PACKWOOD (for himself and Mr. BENTSEN):

S. 3069. A bill to amend the Internal Revenue Code of 1954 with respect to the treatment of incentive stock options; to the Committee on Finance.

TAX TREATMENT OF INCENTIVE STOCK OPTIONS

● Mr. PACKWOOD. Mr. President, I am pleased to introduce legislation today with Senator LLOYD BENTSEN to improve the 1981 incentive stock options rules. I am also delighted that JIM JONES and BILL FRENZEL have introduced the companion legislation in the House of Representatives, H.R. 6421.

The four of us were the prime sponsors of the original incentive stock options legislation enacted in 1981. We have decided to join together again to introduce this legislation because we believe that changes are needed to insure that the incentive stock options law achieves the purposes originally intended.

WHY INCENTIVE STOCK OPTIONS?

Incentive stock options help motivate superior performance by employees. They can help small companies compete with established corporations in attracting top-caliber employees.

Small, growing companies provide more than their share of technological innovation and job growth. They can continue to contribute this sort of economic dynamism, however, only if they are successful in attracting and motivating highly talented employees.

Smaller businesses are often unable to offer the job security or the salary levels that are available in larger corporations. But with the prospect that the stock of the company will grow, stock options in these businesses can provide an incentive for talented individuals to risk their careers in the uncertainties of a new venture.

HOW INCENTIVE STOCK OPTIONS WORK

The workings of the incentive stock options law can best be shown through an example. Assume that in 1984 Jones Corp. gives a stock option to employee A to buy 100 shares of Jones Corp. stock. It is then selling for $10.

By 1986, let's assume, the price of the stock has increased to $20. Employee A pays $1,000 to exercise the option. As a result, employee A becomes the owner of the 100 shares of stock. Finally, assume that employee A sells the 100 shares of stock in 1990, for $30 per share.

If the option is not an incentive stock option, it is taxed as follows. The difference between the option price, $10, and the price at exercise, $20, is taxed to the employee as ordinary income. At the same time, the corporation receives a deduction corresponding to the amount of spread treated as ordinary income by the employee.

In 1990, when the stock is sold, the employee treats the difference between the sales price, $35, and the price at exercise, $20, as capital gains.

Under incentive stock option rules, the tax treatment is different. The employee does not have income at the time the option is exercised. Correspondingly, the corporation loses its deduction based on the spread at exercise which arises if incentive stock options are not used.

When the employee sells the stock in 1990, the entire difference between the sales price, $35, and the option price, $10, is treated as capital gain.

REVENUE EFFECT OF INCENTIVE STOCK OPTIONS

In 1981, the Joint Committee on Taxation estimated that enactment of the incentive stock options legislation increases Federal revenues. This is because tax increases resulting from the loss of the deduction by the corporation, and the eventual capital gains tax payment by the individual, exceed tax decreases resulting from not taxing the spread at exercise.

PROPOSED CHANGES

We believe three changes in the incentive stock options rules are merited.

First, we believe the minimum tax should not apply to the spread at exercise. Minimum tax was made applicable to incentive stock options by the Tax Equity and Fiscal Responsibility Act of 1982. The minimum tax is imposed on tax preferences. But I have trouble seeing where the preference is with incentive stock options in light of the fact that 1981 Joint Tax Committee estimates showed that use of incentive stock options actually results in increased tax payments.

Second, the bill repeals the sequencing rule. Under the sequencing rule, an incentive stock option may not be exercised if a previously issued incentive stock option has not been exercised. The effect of the sequencing rule is to make incentive stock options virtually unavailable to corporations with declining stock prices. Therefore, the desire to increase opportunities for employee stock ownership is thwarted in those firms.

Third, the bill revises the $100,000 limit applicable to incentive stock options. Under current law, companies may grant only $100,000 in incentive stock options per year. The bill replaces that limit with a $100,000 limit on the amount of incentive stock options which are first exercisable each year.

As a result of this change, a company seeking to attract a key management employee could offer, say, $300,000 in options on the first day of employment. However, the employer could not permit more than $100,000 of these options to become first exercisable per year.

The bill does not change the current rule which allows incentive stock options to remain outstanding for up to 10 years. Also, under the bill, as under current law, any outstanding option can be exercised in the year it becomes first exercisable or later so long as it remains outstanding.

Under the bill, for purposes of the $100,000 limit, options granted will remain outstanding until lapse or exercise. However, consistent with the proposed repeal of the sequencing rule, the bill puts no restriction on the order of exercise of options.

We believe this increased flexibility in the working of the $100,000 limit will help businesses attract key management personnel.

LEGISLATIVE PROSPECTS

Mr. President, we are introducing this bill to let the Congress and the public review and respond to these ideas. We look forward to working with interested persons with respect to suggestions for this legislation.

Mr. President, I request unanimous consent that the text of the bill appear in the RECORD following these remarks.

There being no objection, the bill was ordered to be printed in the RECORD, as follows:

S. 3069

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

SECTION 1. TAX TREATMENT OF INCENTIVE STOCK OPTIONS.

(a) Repeal of Application of Minimum Tax.—Paragraph (10) of section 57(a) of the Internal Revenue Code of 1954 (including incentive stock options as an item of tax preference) is hereby repealed.

(b) Repeal of Requirement That Options Are Exercisable Only in Chronological Order, and Modification of $100,000 Limitation.—

(1) IN GENERAL.—Paragraph (7) of section 422A(b) of the Internal Revenue Code of 1954 (defining incentive stock option), is amended to read as follows:

"(7) in the case of an option granted after December 31, 1984, the aggregate fair market value (determined at the time the option is granted) of the stock with respect to which incentive stock options are first exercisable under the terms of the plan by any employee during any calendar year (under all such plans of the employee's employer corporation and its parent and subsidiary corporations) shall not exceed $100,000.".

(2) CONFORMING AMENDMENT.—Paragraph (8) of section 422A(b) is amended by adding "and before January 1, 1985" after "1980,".

SEC. 2. EFFECTIVE DATES.

(a) IN GENERAL.—Except as provided in subsection (b), the amendments made by this Act shall apply to taxable years beginning after December 31, 1984.

(b) SECTION 1(b).—The amendments made by section 1(b) shall apply to calendar years beginning after December 31, 1984.●

● Mr. BENTSEN. Mr. President, I am happy to introduce this legislation with the Senator from Oregon. The bill repairs some serious deficiencies in the stock option provisions of the Internal Revenue Code and helps to ensure the usefulness of stock options as a compensation tool for America's growth companies. It has become well known in recent years that job creation in America results not from the activities of Fortune 500 giants, but from the activities of smaller, more entrepreneurial companies. I think it is crucial, therefore, to take reasonable steps to facilitate the growth and prosperity of those companies. This measure is one particularly appropriate step.

The 1981 tax bill brought into the law what are known as incentive stock options. These replaced so-called qualified stock options and restricted stock options that had been in the law earlier. ISO's are tax preferred in that the spread between the exercise price and the value of the stock is not taxable at the time the option is exercised. Normal tax rules would require that a tax be paid at that point—and the tax would be paid at ordinary-income rates since the gain on the option would be considered wage income. But the gain on an ISO is taxable only when the stock is finally sold, and the gain is a capital gain.

ISO's are a powerful compensation tool for small, cash-poor companies. They permit the company to attract talented employees with the promise of a stake in the company. If the company prospers, the employees prosper. ISO's also provide employees with an incentive to stay with the company to ensure both the continued success of the company and the resulting high value for the company's stock.

However, several statutory limitations on ISO's seriously hinder the effectiveness of this compensation tool. Our bill removes these limitations, as follows:

First, the bill repeals the provision in the 1982 tax bill that made ISO's a tax preference. That provision had the effect of applying the alternative minimum tax to the exercise of an ISO. For example, if an employee purchases stock under an ISO for $10 and the stock has a value of $20, the gain of $10 is subject to the minimum tax at the time of exercise. The problem is that the employee may not have the cash to pay the tax. Under the ISO rules, he is not even permitted to sell the stock to raise the cash—if he sells within 1 year, tax-preferred treatment is precluded, and his entire gain is treated as wage income. A worse problem is that no basis step up is provided to account for the payment of minimum tax. In other words, the employee in the above example could pay a minimum tax on his gain of $10, and then later sell the stock for $20 and pay a full capital gain tax on that same gain.

The unfortunate fact is that because of these problems, ISO's have not become the popular and broadly used tool that they should be. It is often bad tax planning for an employer to offer its employees ISO's. For these reasons, our bill repeals the minimum tax applicability and ensures that the beneficiary of an ISO will pay a tax only at the time he sells the stock purchased under the ISO.

Second, the bill also repeals the sequential exercise rule. This rule provides essentially that an employee must exercise ISO's in the order received. Unfortunately, this rule has the result—of completely eliminating the usefulness of ISO's in certain circumstances. For example, suppose an employee receives an option to buy stock at $10 per share. Subsequently, prior to exercise, the value of the stock falls to $5 per share. If the employer then grants new ISO's with a lower exercise price, the employee won't be able to exercise them until he exercises the old ISO's and incurs a loss. As a practical matter, this means that if a company's stock price falls, ISO's are thereafter useful only for new employees or for employees who have no unexercised ISO's outstanding. The rule also blunts the effectiveness of ISO's in attracting new employees because employees know that ISO's will not be available to them, as a practical matter, after the first year if the price of the company's stock falls. For these reasons, the bill does away with the sequential exercise rule and permits employees to exercise ISO's in any order. It should be noted that the bill retains the requirement that an ISO not be exercisable after 10 years after the grant. This means that any unexercised ISO's would simply lapse after 10 years.

Third, finally, the bill liberalizes the $100,000 yearly limitation. Currently, the ISO rules limit the amount of ISO's an employee may be granted in 1 year to $100,000 in value of stock. This means that employers are precluded form offering large up-front ISO's to attract new employees. Our bill changes this rule to impose the $100,000 limit not on the amount of ISO's that can be granted but on the amount of ISO's that are first exercisable in any year. Thus, an employer could offer an employee an ISO of, for example, $500,000 in the employee's first year and specify that $100,000 of the ISO is first exercisable in 2 years, and then $100,000 in 3 years, and so forth. The employee could exercise each $100,000 increment in the year when it is first excercisable or in any other year before the ISO lapses. Again, the 10-year rule will still apply, and in addition, the rule treating an option as outstanding until exercise or lapse will remain in the law.

In summary, I believe that this is an important piece of legislation for ensuring the continued vitality of our smaller, entrepreneurial, high-technology companies. With the Senator from Oregon, I will seek to have this legislation enacted into law at the earliest opportunity in the next Congress.

The CHAIRMAN. Senator Bumpers.

Senator BUMPERS. I'll be brief, Mr. Chairman.

I want to say to both of the gentlemen, I think you've both made excellent statements. It's a matter of great importance to me, this capital gains issue, and it always has been.

There are two things about capital gains. We put capital gains in the Tax Code in the first place—I'm not sure when that was—but the idea was it would protect the investor against inflation and it would encourage investments, risk capital.

Now I have to tell you that I have steadfastly opposed the reduction of the holding period. When I came to the Senate the capital gains rate was 48 or 49 percent—I forget which—and the holding period at that time I believe was 2 years, was it not?

Mr. MCMURTRY. I think it was 1 year, but——

Senator BUMPERS. Maybe it was just 1 year, but, in any event, you recall in 1978 we reduced the rate to 28 percent and left the holding period at 1 year. Then we reduced the holding period, then we reduced the rate to 20 percent, then we reduced the holding period to 6 months. Now some of those things I didn't oppose and some I did, but my position has always been strongly to favor capital gains but to tilt it toward an incentive for risk capital.

Mr. McNeish makes a very valid point here: It is the differential more than anything else that takes away the incentive here. You have a 30-percent differential now between the top personal rate and the capital gains rate. The House bill goes from 38 to 22, 38 top rate, 22 percent capital gains rate. I don't know what the impact—I don't know what the Treasury revenue impact is by raising it 22 percent. I suspect it's not very great. I don't know why they want to tinker with it, frankly, if you're going to raise it from 20 to 22 percent. That never did make much sense to me.

But if we were going to wind up with the House bill in the Senate and there wasn't anything I could do about it, my preference would be, if you're going to have a 22-percent rate or a 6-month holding period, then one way you might get additional incentives into this capital gains rate is to, for example, go to 17.5 percent for 1 year or maybe even 15 percent and go to 10 percent for a 2-year holding.

What would you say to that, Mr. McMurtry?

Mr. MCMURTRY. You brought up a subject on which I get into giant arguments with some of my colleagues. I'll give you my personal opinions.

I believe that I would encourage longer holding periods. I believe that people who make investments really for the longer term in fact deserve more attractive treatment in taxation.

In most of the investments that people in our association make, particularly if you're investing in a startup company, if you see any liquidity, if you see any money coming back from that other than residual of a total loss, if you see any money coming back to you in less than 5 to 6 years, it's classed as a miracle. Most of our returns begin in the sixth or seventh year, and hopefully you can liquidate most of your holdings in the seventh, eighth, ninth year, or you can distribute them out to your partners.

I have never found it possible to argue strongly against lower rates for longer holding periods. Many of my friends argue quite vehemently that lower rates for longer holding periods really interfere with the operation of the market. It is very true that venture capital is only one small part of the entire market process. Most of our companies are tremendously dependent upon the availability and viability of healthy equity markets. If a longer holding period would put a damper on the equity markets in general in this country, then I would have to say that would be a bad thing for the country.

Senator **BUMPERS**. Right now let me make two comments. No. 1, I might even be willing to say that if you either invest in a company which does nothing but basic research and you're willing to make that kind of an investment, say, for 3 years, you should pay no income tax, or maybe 4 years; get off scott free if you're willing to invest for that period of time in basic research.

Incidentally, the Japanese Government invests $12 in basic research for every $1 the United States Government invests in basic research.

Mr. **MCMURTRY**. That's right.

Senator **BUMPERS**. That's one of the reasons they're getting light years ahead of us in this international arena.

I was going to make two points. The other point I was going to make is there are thousands of stocks put out by investment banking houses every year for new companies. A lot of them are very good ideas, and I've invested in some of them. But the truth of the matter is those stocks are touted and they go from $2 to $10 within 6 or 8 months, and everybody starts bailing out because the risk of those is great and not 1 out of 20 makes it.

Now if you're going to go with a new company and you're inviting risk capital, I'm not at all sure when it's a new company, new idea, that you not ought to let them go scott free if they're willing to invest, say, for 3 years. I mean, that's what really makes them go in this country, isn't it?

Mr. **MCMURTRY**. It's an interesting thought. Several years ago the California Legislature did pass a bill in which investments in small businesses, equity investments in small businesses held for 3 years, had no tax, no capital gains tax at the State level. The program has been in place too short a period of time really to make any kind of measurement of those results.

Senator **BUMPERS**. Mr. McNeish, did you want to comment on that?

Mr. **MCNEISH**. From a narrow perspective, Senator Bumpers, our industry invests in terms of no less than 5 years. Simply from that perspective, we would support the proposition of a longer holding period. We're officially on record as saying that.

Senator **BUMPERS**. I'd let you off free. I wouldn't make you pay anything. [Laughter.]

Mr. **MCNEISH**. We accept. That's a deal.

I support the points that Burt has made in expressing his personal point of view. I think that the offset to the counterargument that he suggests was made by others is that a 6-month holding period also interferes with that marketplace, and it may interfere in a very negative way because you get to such a short period of time that there is very little difference between ordinary income and capital gains, and the distinction in terms of investor incentives is lost.

Senator BUMPERS. I don't think, if I go out and I invest in the stock market and try my best to invest in things that I'm not going to have to vote on, unlike members of the Virginia Legislature, but anyway——

[Laughter.]

I don't see any risk. If I go out and put $10,000 or $20,000 in IBM and I hang onto it for 6 months, there's a minor risk there, but nobody thinks IBM stock is going to go down. It may not go up more than 10 or 20 percent a year, but if it goes up 20 percent, that's a lot better than buying a CD. There's just not very much risk associated with buying a good stock like General Motors or some of those other stocks. I personally believe that we have done the wrong thing in allowing people to take a 20-percent capital gains rate against a 50-percent top rate for investing that way.

Mr. Chairman, I won't take any more time.

I thought both of your statements were excellent.

The CHAIRMAN. Thank you very much, Senator Bumpers.

Gentlemen, thank you very much. There might be further questions for response in the record.

Mr. McMURTRY. Thank you.

Mr. McNEISH. Thank you.

The CHAIRMAN. Our last panel consists of Jenanine Hanson, representing the U.S. Chamber of Commerce; Kent Colton, National Association of Home Builders; and Mario Borini, partner of Seidman & Seidman, certified public accountants.

Jeanine, representing the U.S. Chamber of Commerce, why don't you lead off?

STATEMENT OF JEANINE HANSON, ACCOUNT EXECUTIVE, LINSCO, ALEXANDRIA, VA; REPRESENTING THE U.S. CHAMBER OF COMMERCE

Ms. HANSON. Mr. Chairman, my name is Jeanine Hanson. I'm appearing today on behalf of the Chamber of Commerce of the United States. The chamber is the largest federation of business and professional organizations in the world. I am with LINSCO Corp., a small investment firm in northern Virginia and a member of the chamber's small business council. Previously I spent 12 years as a partner in a small accounting firm which provided services for small business.

With me today are Deborah Aiken, tax attorney in the tax policy center of the chamber, and Donald Berno, associate manager for legislation at the small business center of the chamber.

We wish to thank the Small Business Committee for the expeditious manner in which this hearing was scheduled. We're particularly interested in the impact of H.R. 3838 or any other tax reform bill on small business, as over 92 percent of the chamber's membership is small business; that is, with less than 100 employees.

The U.S. Chamber believes that tax reform should promote economic growth, stimulate capital formation, encourage technological advancement, enhance international competitiveness, and improve employment opportunities. The chamber does not believe that H.R. 3838 accomplishes these goals.

We believe also that Congress should concentrate on spending reductions first. The chamber's members are far more concerned with the size of the Federal deficit and the need to control Government spending than they are with reforming the tax bill.

Economic stagnation has an utterly catastrophic effect on small business. When the overall economy is growing, small businesses grow and prosper, but when the economy stagnates or declines, small businesses suffer disproportionately.

Economists, liberal and conservative, have stated that the House bill is antigrowth. The recent Senate Finance Committee hearings emphasized that fact. One study estimates that the bill would reduce real gross national product a total of $145 billion between 1986 and 1991. Most of this decline is borne by investment in producers' durable equipment which would fall by a cumulative $136 billion over a 6-year period.

U.S. exports are projected to fall while consumer spending enjoys about $5 billion increase. Both the civilian unemployment rate and the Federal budget deficit would be exacerbated if the House bill is enacted. The unemployment rate would be 1.3 percentage points higher in 1991 if the bill is enacted, and the Federal budget deficit will increase by $25 billion.

Because most small businesses are unincorporated, the reduction of the individual tax rate is of tremendous importance to small business. The maintenance of the graduated rate structure for small incorporated business is essential to avoid a dramatic rate increase on many small businesses.

The repeal of the investment tax credit and the replacement of the accelerated cost recovery system with the incentive depreciation system would increase the after-tax cost of capital by as much as 19 percent even while considering the reduction in the tax rate.

The threat of a major decline in the rate of investment in this country and the resulting negative impact on the economy is as serious to small business as it is to other businesses. During the recession of the early eighties 500,000 small businesses failed, and one study demonstrates that at least 20 percent of the net investment in the 1982–84 period was directly attributable to changes in investment incentives. These incentives directly aided the small business community by lowering the after-tax cost of investment.

The results of the State meetings preceding the White House conference indicate that small business owners from all over the country are concerned about capital cost recovery. ITC was ranked as a major issue by 18 conferences, and the retention of ACRS was supported with 7 recommendations.

Reflecting these concerns, the chamber recommends that an adequate system of capital cost recovery should be retained. Expensing provides the simplest method for small business. The White House conference's State meetings also resulted in showing 14 recommendations opposing taxation fringe benefits, and there were also 12 recommendations of a moratorium on tax changes.

Small businesses have a great deal of difficulty keeping up with the changes in the tax law that are being enacted almost every year. In 1984 the employee benefit area was totally revamped and now it is being considered again in the context of tax reform. Employee benefits should be left intact at this time, as the burden for small businesses is too great when they have to repeatedly hire professionals to make sure their plans qualify under the changing rules.

We were very relieved to see that H.R. 3838 does not limit the use of cash methods for small businesses, and we also think that businesses grossing less than $500,000 annually should be able to use the cash method even if they have inventory.

Thank you for the opportunity to present our views on some of the provisions that are being considered in the tax reform debate that are of particular importance to small business.

I will be happy to answer any questions that the committee may have.

[The prepared statement of Ms. Hanson follows:]

STATEMENT
on
TAX REFORM
before the
SENATE SMALL BUSINESS COMMITTEE
for the
U.S. CHAMBER OF COMMERCE
by
Jeanine Hanson
February 6, 1986

My name is Jeanine Hanson, CPA, and I am appearing today on behalf of the U.S. Chamber of Commerce. The Chamber is the largest federation of business companies and associations in the world. I am with LINSCO Corporation, a small investment firm in Northern Virginia, and a member of the Chamber's Small Business Council. Previously, I spent 12 years as a partner in a small accounting firm which provided accounting services for small businesses. With me today is Deborah Aiken, Tax Attorney in the Tax Policy Center of the Chamber, and Donald Berno, Associate Manager of Legislation for the Small Business Center of the Chamber.

Tax reform is foremost on the minds of business people throughout the country because of the uncertainty of the consequences of their current business transactions. We thank the Small Business Committee for the expeditious manner in which this hearing was scheduled.

We are particularly interested in the impact of H.R. 3838 or any other tax reform bill on small businesses as over 92% of the Chamber's membership is small businesses with less than 100 employees. The Chamber is structured to protect the interests of small business. Our Taxation Committee has a Small Business Subcommittee that examines all current tax issues and makes recommendations which are passed through the full taxation committee and on to the Board to become policy.

The Chamber also has a Council of Small Business, which considers all small business issues, including but not limited to tax, and makes its recommendation directly to the Chamber's Board. In fact, the Council is the only group on the 13 standing committees that has standing to become involved in other committees' jurisdiction.

Summary

The U.S. Chamber believes that tax reform should promote economic growth, stimulate capital formation, encourage technological advancement, enhance international competitiveness and improve employment opportunities. The Chamber does not believe that H.R. 3838 accomplishes those goals.

Although we support tax reform that would stimulate economic growth, we believe that Congress should concentrate on spending reduction first. The Chamber's members are far more concerned with the size of the federal deficit and the need to control government spending than they are with reforming the tax code. For this reason, we believe that Congress should set aside tax reform until action on the budget has been completed.

The Effect of the Economy on Small Business

The recession lasting from July 1981 to November 1982 caused 500,000 small businesses to fail. That statistic translates into millions of households in which the breadwinners are thrown out of work, in which the owners' life savings are totally lost, and in which the efforts of generations spent building a business are destroyed in a few short months.

Economic stagnation has an utterly catastrophic effect on small businesses. When the overall economy is growing, small businesses grow and prosper; but when the economy stagnates or declines, small businesses suffer disproportionately. Although this fact should surprise no one, in the tax policy debate over the House approved tax reform bill, it is simply being ignored by those ostensibly concerned about the fate of small business in America.

Small businesses are high risk ventures. They do not have the same access to borrowed capital or new equity capital as do larger concerns. Lacking product and geographical diversification, small businesses are less able to weather reverses in a particular market or locale than their larger counterparts. Small business entrepreneurs often have less experience in their line of business than managers in larger firms. Thus, many are less able to survive the vicissitudes of a shrinking economy.

Most small businesses are family owned or controlled. They are generally capitalized by the equity contributions of family and friends and borrowing from banks. Often, if a small business suffers a serious reverse, banks are unwilling to risk lending it more capital, and the owners are unable to contribute more equity because the business itself is their major asset. Moreover, most small businesses are undercapitalized. Thus, in a recession many small businesses simply run out of resources with which to preserve and wait for better times to reappear.

Small businesses often rely on larger firms for their success. This is obvious, for example, in the case of small firms that produce parts for larger concerns or whose sales market substantially consists of larger firms or the employees of larger firms. It is less obvious, but just as true, of small businesses located in areas that rely heavily on particular industries. When the steel, mining, or timber industries collapsed, for example, retail stores in towns and cities relying on those industries were badly hurt. Their situation often became desperate, and a drive through towns in these distressed areas will reveal vacant store front after vacant store front. Large geographically diversified retail stores or wholesalers can afford to watch some of their major markets weaken -- though it is hard to understand why it will profit even a large retailer or wholesaler for the overall economy to weaken, reducing disposable income, lowering standards of living and increasing unemployment. The future of the mom-and-pop retail store, however, is inextricably tied to the future of the larger firms in its locale.

H.R. 3838 WOULD HARM ECONOMIC GROWTH

Unanimity is rare among economists. But economists, liberal and conservative, are virtually unanimous that the House bill is anti-growth. The recent Senate Finance Committee hearings emphasized that fact. In fact, recently completed econometric analysis of the House tax reform bill that was performed for the U.S. Chamber of Commerce by the consulting firm of Laurence H. Meyer and Associates shows that the bill would significantly harm economic growth.

The study estimates that the bill would reduce real gross national product a total of $145 billion between 1986 and 1991. Nonresidential investment will decline $158.9 billion if the bill is enacted. Most of this decline is borne by investment in producers' durable equipment, which would fall by a cumulative $136.3 billion over the six-year period. U.S. exports are projected to fall by $14.2 billion, and consumer spending slightly to increase by $5.1 billion. Both the civilian unemployment rate and the federal budget deficit would be exacerbated if the House bill is enacted. In 1991 the unemployment rate will be 1.3 percentage points higher, and the federal budget deficit will increase by $25.3 billion.

Rate Reduction

Because most small businesses are unincorporated, the reduction of the individual tax rate is of tremendous importance to small businesses. The maintenance of the graduated rate structure for small incorporated businesses is essential to avoid a dramatic rate increase for many small businesses. Under the graduated rate structure included in H.R. 3838, many small businesses will experience base broadening while receiving no reduction in rates. These small businesses would be the only taxpayers not to receive rate reduction under the tax reform bill. We believe this should be remedied.

Capital Cost Recovery

The repeal of the Investment Tax Credit (ITC) and the replacement of the Accelerated Cost Recovery System (ACRS) with the Incentive Depreciation System (IDS) would increase the after-tax cost of capital by as much as 19%, even when considering the reduction in the tax rate. (See Appendix 1.) This increase in the after-tax cost of capital investment contributes to a cumulative $158.9 billion decline in nonresidential investment during the six years following implementation of the bill. (See Appendix 2 for table.) The threat of a major decline in the rate of investment in this country and the resulting negative impact on the economy are as serious to small businesses as they are to other businesses. During the recession of the early 1980s, 500,000 small businesses failed.

Michael Boskin of Stanford University recently completed a study under National Chamber Foundation auspices entitled The Impact of the 1981-1982 Investment Incentives on Business Fixed Investment. That study demonstrates that at least 20 percent of net investment in the 1982-1984 period was directly attributable to changes in investment incentives.

These incentives directly aided the small business community by lowering the after-tax cost of investment. More importantly, they laid the groundwork for what may prove to be the longest and strongest economic recovery in this century. And it is this strong economic growth that provides small businesses with the opportunity to prosper and succeed.

The results of the White House Conferences indicate that small business owners from all over the country are concerned about capital cost recovery. The ITC was ranked as a major issue by 18 conferences, and the retention of the ACRS was supported with seven recommendations from seven states.

Reflecting these concerns, the Chamber recommends that an adequate system of capital cost recovery should be retained. Expensing provides the simplest method for small businesses, because they do not have to deal with complicated depreciation rules. We believe that expensing also provides the most neutral system for writing off the cost of capital. We, therefore, recommend a tax system that allows expensing or its equivalent for all assets. The present system, which combines the use of the ACRS and the ITC has the approximate present value of expensing and is, therefore, an adequate capital cost recovery system.

Capital Gains

The retention of a significant differential between the ordinary income rates and the tax rate on capital gains is very important to small businesses. They traditionally have a problem raising venture capital, and lower capital gains rates encourage potential investors to accept the risk. H.R. 3838 repeals the capital gains rate differential for corporations and raises the capital gains tax rate for individual taxpayers. The Chamber supports a capital gains rate for both corporations and individuals that is significantly lower than the rate on ordinary income.

Employee Benefits

The White House Conferences state meeting results show fourteen recommendations opposing taxation of fringe benefits. There were also twelve recommendations of a moratorium on tax changes. H.R. 3838 makes many changes to the nondiscrimination rules in the area of employee benefits. Small businesses have a great deal of difficulty keeping up with the changes in the tax law that are being enacted practically yearly. In 1984 the employee benefits area was totally revamped, and now it is being considered again in the context of tax reform.

Employee benefits should be left intact at this time, as the burden for small businesses is too great when they repeatedly have to hire professionals to make sure their plans qualify under the changing rules.

The House bill, H.R. 3838, would limit contributions to 401(k) plans to $7,000 per year. Any contributions to these 401(k) plans would reduce the amount that could be contributed to an Individual Retirement Account. We believe that this is a serious mistake. This country has a very low rate of savings, and 401(k) plans have become increasingly popular. Small businesses have difficultly attracting qualified employees, because the large companies with whom they are competing for good employees often can offer better benefits. The limitation on the 401(k) plans is just one more impediment for small businesses in their attempts to maintain an experienced, well-qualified work force.

Inventory

H.R. 3838 contains a simplified LIFO system, which would be of great value to many small businesses. We suggest that there could be other improvements in the area of inventory. Presently the cash method of accounting may only be used by businesses if they have no inventory. The Chamber believes that businesses with gross income of under $500,000 should be allowed to use the cash method regardless of whether they have any inventory.

Accounting Methods

Several of the tax reform plans previously presented would have limited the use of the cash method of accounting for tax purposes. Under present law, a taxpayer generally may use the cash method of accounting for tax purposes if the business has no inventory. Under the cash method of accounting, income is only taxable when received, and expenses cannot be deducted until paid. The accrual method requires taxation of income when the right to receive that income becomes fixed, although the income may not be received, and expenses are deducted in the year that the fact and amount of the liability can be established.

We were very relieved to see that H.R. 3838 does not limit the use of the cash method for small businesses. This is an important provision to retain in any final tax reform package. As mentioned above under the heading "Inventory," we also think that businesses grossing less than $500,000 annually should be able to use the cash method even if they have inventory.

Conclusion

Thank you for the opportunity to present our views on some of the provisions that are being considered in the tax reform debate that are of particular importance to small businesses. Your concern and the concern of others for small businesses are being rewarded by a renewed growth and prosperity throughout the country. Small businesses need to be fostered and encouraged, while still allowing them the individualism and initiative that can make them a success. However, we must be careful not to categorize concerns about taxes into big and small business issues.

A big business is just a small business that has grown, and the tax code needs to help small businesses grow. Should business once again be weighed down by taxes and the cost of obtaining capital for expansion, by reduction in the cost recovery allowance, loss of the investment tax credit, and other cut backs in incentives to business, small businesses, being in the most precarious position, will be the first to be injured. This country needs a strong small business sector to have a booming economy, but small business needs a healthy economy to have the chance to succeed.

APPENDIX 1

Impact of House Ways & Means Tax Reform Bill on the Rental Price of Investment

	Years from Implementation					
	1	2	3	4	5	6
	1986	1987	1988	1989	1990	1991
Business Capital						
Equipment						
CBO Base	18.6	18.8	18.8	18.5	18.1	17.8
HW&M	22.0	22.2	22.1	21.8	21.3	20.9
Difference	3.4	3.4	3.3	3.3	3.2	3.1
Percent	18.3	18.1	17.6	17.8	17.7	17.4
Structures						
CBO Base	18.6	19.6	20.4	20.6	20.6	20.8
HW&M	20.7	21.7	22.4	22.5	22.4	22.4
Difference	2.1	2.1	2.0	1.9	1.8	1.6
Percent	11.3	10.7	9.8	9.2	8.7	7.7
Residential Buildings						
Single Family						
CBO Base	14.4	13.3	13.4	13.5	13.6	13.6
HW&M	15.0	13.9	13.9	14.0	14.0	13.9
Difference	0.6	0.6	0.5	0.5	0.4	0.3
Percent	4.2	4.5	3.7	3.7	2.9	2.2
Multi Family						
CBO Base	16.5	15.2	16.3	15.5	15.6	15.7
HW&M	17.7	16.3	16.4	16.5	16.6	16.5
Difference	1.2	1.1	0.1	1.0	1.0	0.8
Percent	7.3	7.2	0.6	6.5	6.4	5.1
Consumer Durables						
CBO Base	21.3	20.9	20.3	19.8	19.3	18.8
HW&M	21.6	21.1	20.5	20.0	19.4	18.9
Difference	0.3	0.2	0.2	0.2	0.1	0.1
Percent	1.4	1.0	1.0	1.0	0.5	0.5
Inventories						
CBO Base	7.0	6.9	6.5	6.3	6.2	6.0
HW&M	7.1	6.9	6.4	6.1	5.9	5.7
Difference	0.1	0.0	-0.1	-0.2	-0.3	-0.3
Percent	1.4	0.0	-1.5	-3.2	-4.8	-5.0

Source: Laurence H. Meyer and Associates

APPENDIX 2

Impact of House Ways & Means Tax Reform Bill
on the U.S. Economy

	Years from Implementation							
	1	2	3	4	5	6	Average Impact	Cumulative Impact
	1986	1987	1988	1989	1990	1991		
GNP								
CBO Base	1728.2	1785.3	1840.6	1901.3	1963.2	2023.6	1874.0	
HW&M	1725.2	1780.2	1826.6	1873.8	1921.7	1971.7	1849.9	
Difference(1)	-3.0	-5.1	-14.0	-27.5	-41.5	-51.9	-24.2	-143.0
Percent(2)	-0.2	-0.3	-0.8	-1.4	-2.1	-2.7	-1.3	
Consumption								
CBO Base	1132.1	1162.4	1191.5	1225.7	1265.1	1308.4	1214.2	
HW&M	1133.7	1169.9	1198.7	1228.8	1261.8	1297.4	1215.1	
Difference(1)	1.6	7.5	7.2	3.1	-3.3	-11.0	0.8	5.1
Percent(2)	0.1	0.6	0.6	0.3	-0.3	-0.8	0.1	
Nonresidential Investment								
CBO Base	226.5	235.5	245.1	257.2	268.2	279.0	251.9	
HW&M	222.4	223.3	223.1	225.2	227.4	231.2	225.4	
Difference(1)	-4.1	-12.2	-22.0	-32.0	-40.8	-47.8	-26.5	-158.9
Percent(2)	-1.8	-5.2	-9.0	-12.4	-15.2	-17.1	-10.5	
Equipment								
CBO Base	165.3	172.2	179.5	189.5	199.0	210.2	186.0	
HW&M	161.7	161.3	160.1	161.8	164.3	170.2	163.2	
Difference(1)	-3.6	-10.9	-19.4	-27.7	-34.7	-40.0	-22.7	-136.3
Percent(2)	-2.2	-6.3	-10.8	-14.6	-17.4	-19.0	-12.2	
Structures								
CBO Base	61.1	63.3	65.7	67.7	69.1	68.8	66.0	
HW&M	60.7	62.0	63.1	63.4	63.0	61.0	62.2	
Difference(1)	-0.4	-1.3	-2.6	-4.3	-6.1	-7.8	-3.8	-22.5
Percent(2)	-0.7	-2.1	-4.0	-6.4	-8.8	-11.3	-5.7	
Residential Investment								
CBO Base	60.6	63.5	66.0	65.6	66.3	66.8	65.1	
HW&M	59.8	63.1	66.4	65.7	65.8	65.6	64.7	
Difference(1)	-0.8	-0.4	0.4	0.1	-0.5	-1.2	-0.4	-2.4
Percent(2)	-1.3	-0.6	0.6	0.2	-0.8	-1.8	-0.6	
Exports								
CBO Base	141.5	144.8	148.8	153.9	160.0	166.5	152.6	
HW&M	141.4	144.4	147.6	151.5	155.9	160.5	150.2	
Difference(1)	-0.1	-0.4	-1.2	-2.4	-4.1	-6.0	-2.4	-14.2
Percent(2)	-0.1	-0.3	-0.8	-1.6	-2.6	-3.6	-1.6	
Unemployment Rate(%)								
CBO Base	6.9	6.8	6.8	6.3	6.0	5.4	6.4	
HW&M	6.9	7.0	7.2	7.1	7.0	6.7	7.0	
Difference(3)	0.0	0.2	0.4	0.8	1.0	1.3	0.6	NA
Implicit Price Deflator for GNP(%ch)								
CBO Base	3.9	4.0	3.9	3.8	3.9	4.1	NA	
HW&M	4.0	4.1	4.0	4.0	4.0	3.9	NA	
Difference(3)	0.1	0.1	0.1	0.2	0.1	-0.2	NA	NA
Treasury Bill Rate(%)								
CBO Base	7.4	7.3	7.1	7.0	7.0	7.0	7.1	
HW&M	7.4	7.3	7.0	6.8	6.7	6.6	7.0	
Difference(3)	0.0	0.0	-0.1	-0.2	-0.3	-0.4	-0.1	NA
Corporate Bond Rate(%)								
CBO Base	9.8	9.2	9.1	9.0	9.0	8.9	9.2	
HW&M	9.8	9.2	9.0	8.9	8.8	8.6	9.1	
Difference(3)	0.0	0.0	-0.1	-0.1	-0.2	-0.3	-0.1	NA
***NIA(5) Deficit(bill. current $)**								
CBO Base	-204.6	-226.3	-226.9	-241.1	-262.4	-293.3	-242.4	
HW&M	-197.1	-238.0	-240.4	-260.0	-285.5	-318.6	-254.6	
Difference(4)	7.5	-11.7	-13.5	-18.9	-23.1	-25.3	-11.9	NA

(1) Difference from base in billions of real (1972) dollars.
(2) Percent difference from base.
(3) Percentage point difference from base.
(4) Difference from base in billions of current dollars.
(5) National Income Accounts.
NA Not applicable or not available.

Source: Laurence H. Meyer & Associates.

* National Income Accounts

The CHAIRMAN. Thank you very much.

We'll move now to our next witness, Kent Colton, representing the National Association of Home Builders.

It is a pleasure to have you with us.

STATEMENT OF KENT COLTON, EXECUTIVE VICE PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. COLTON. Thank you very much, Senator.

As you indicated, my name is Kent Colton, and it's an honor for me to appear before you today as the executive vice president of the National Association of Home Builders, which represents more than 137,000 members.

You have correctly recognized us as a small business since about 70 percent of our builders are small builders. We define a small builder as one who builds less than 25 units per year and, in fact, 50 percent of our members build less than 10 units annually.

It is very appropriate that this committee take a close look at the potential impact of tax reform on small business. Often provisions are enacted with good intentions but with no real understanding as to what their impact will be. I am sure we all remember what happened with automobile recordkeeping when that was imposed in the 1984 Tax Act and then was substantially modified.

A key concept—and it's been mentioned by others—when it comes to our builders is the area of certainty. We need to know that decisions based on the state of the law today will not sour in the future because Congress has decided to change the law. However, since 1980 there have been three major revisions in the tax law. Because of the rapidity with which the tax law has changed in recent years, it has been extremely difficult for our business people to plan with any certainty. Now Congress is considering a fourth major change which will add significant new complexities to the law and substantially increase the cost of doing business. Before we proceed, it is essential that the Senate look carefully at tax reform to see if the benefits really justify the cost.

No one can object in concept to the goals of simplicity, growth, and fairness, but, unfortunately, the House tax bill does not achieve these objectives. Let me discuss each briefly as it relates to homebuilding.

If anyone thinks H.R. 3838 amounts to tax simplification, you just have to review the 1,357 pages of the bill and then consider, as we have tried to do, what the transition means for one industry, the housing and homebuilding business.

Regarding the impact on growth or the economic impact of the tax bill, you've already heard mentioned today the general concern about the impact on the economy. Let me stress that there will be a negative impact when it comes to housing.

Our analysis indicates that in the first year following enactment single-family starts will drop by something in the range of 100,000 to 110,000 thousand units and the impact on the multifamily area will be even more significant. Our computer models indicate that for a multifamily project conventionally financed the economically feasible required rents would have to go up by 24 percent. That means that multifamily housing will come to a screeching halt and, in essence, we predict at least a 50-percent drop. If we took 1985 levels, that would mean a drop in multifamily housing starts of 250,000 units.

Finally, when we look at fairness, just consider the impact of a few provisions in the House bill on the complexity and cost of doing business for the homebuilder. Obviously, in our testimony we go through a lot. I'm not going to try to do that, but I'll just list a couple.

Repeal of the 10-year writeoff for construction period interest and taxes would add significantly to the cost of housing. The taxation of borrowed money when installment notes are placed as collateral to secure the borrowing would add to the price of homes and would be unfair if the treatment is different for pledged collateral than it is for all other users of installment sales.

The taxation of contributions in aid of construction to public utility companies will increase the builders' infrastructure costs significantly.

Finally, annual certification by a rental project operator that the project is in compliance with the multifamily industrial development bond set-aside requirements will add significant complexity to the process of managing multifamily housing projects and may, in fact, make it too complex for some people to enter that business.

Quickly, let me mention two other items that would have a very detrimental effect on overall investment and capital formation—I know two issues that you are very concerned about.

The stretchout of depreciable lives for most buildings from 19 to 30 years will be significant in the housing area, as will be the treatment of tax-exempt industrial development bond interest and excess passive activity losses as tax preference items for purposes in the minimum tax.

In conclusion, Senator, let me just stress two points: If the Senate proceeds with tax reform, we strongly urge you to make sure that transition rules and liberal grandfather rules are provided, so that business may be able to plan with certainty in order to minimize economic disruption.

Right now we're in a situation where we have significant problems because the House bill has passed; it's not clear what the Senate is going to do; yet, the date of enactment of some provisions is January 1, 1986. That's a major problem.

Second, because of the adverse impact of tax reform on small business in general and housing in particular, we agree with what appears to be the sentiment of the Senate—that you must first turn your full attention to the Nation's No. 1 domestic problem, deficit reduction, before acting on tax reform.

Thank you for this opportunity to testify, and I'll certainly be glad to answer any questions you might have.

[The prepared statement of Mr. Colton follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

COMMITTEE ON SMALL BUSINESS

on

IMPACT OF TAX REFORM ON THE HOUSING INDUSTRY

February 6, 1986

Mr. Chairman and Members of the Committee:

My name is Kent Colton and it is an honor to appear before you today as Executive Vice President of the National Association of Home Builders (NAHB), representing more than 137,000 members.

Mr. Chairman, it is very appropriate that your Committee is examining the potential impact of tax reform on small business. Since 1980, there have been three comprehensive revisions to the tax law. Now, the Congress is considering a fourth. Because the tax law has changed so frequently in recent years, it has been very difficult for small business to plan and function with any certainty. Thus, we urge the Senate to consider the impact of tax reform upon small business, both in terms of additional cost of doing business and in terms of the complexity it adds to the day-to-day conduct of business.

NAHB is particularly pleased to have this opportunity to address this committee since approximately 70% of our builders are "small builders" (builders building less than 25 units annually).

This statement provides a brief overview (Part I) of the concerns of housing with tax reform, followed by a more detailed statement of the impact of proposed tax reform on single-family housing (Part II) and multifamily housing (Part III), a discussion of provisions that would affect both single-family and multifamily housing (Part IV), and a discussion of the economic impact of proposed tax reform on housing (Part V).

I. Overview

The Federal Government has, for a long time, been committed to encouraging housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals. Homeowners have relied on the deductibility of mortgage interest and property taxes to help them achieve home ownership, and renters have benefited from the tax incentives provided for individuals to invest in rental housing. This tax policy has made possible increased rates of home ownership, a comfortable standard of housing for most households, and a steady decline in the amount of substandard housing.

Affordable rental housing is an essential part of our social policy today. Rental housing must be available for those who are o The bill would place substantial new limitations on mortgage revenue bonds, as well as subject them to a much stricter volume cap.

o The bill would treat loans for which installment obligations are pledged as security as payments on the pledged obligations. This would severely restrict the utility of homeowner bond (builder bond) financing.

o The bill would provide that taxpayers who itemize their deductions (generally home owners) would be limited to a $1,500 personal exemption, while all other taxpayers would be entitled to a $2,000 personal exemption. Moreover, by increasing the standard deduction to an amount substantially above the deductible non-housing expenses of most households, it would reduce the effective value of deductions for the expenses of home ownership.

NAHB estimates that single-family housing starts would decline by about 110,000 units in the first year after enactment of H.R.3838. (Part V discusses the likely economic impact of H.R.3838.)

Likewise, the impact of H.R.3838 on multifamily housing would be quite dramatic. We are concerned with the following provisions:

o The bill would lengthen the depreciable lives for most residential buildings from 19 years to 30 years, and change the depreciation method from 175% declining balance to straight line.

o The bill would provide several new restrictions for multifamily industrial development bonds, as well as subject them to a strict volume limitation.

o The bill would limit the amount of interest expense that could be deducted by a "passive investor" (e.g., a limited partner) to $20,000 per year ($10,000 for a single taxpayer).

unable financially, or who do not desire, to own their own home. As I will explain, further, rental housing would not be an attractive investment without tax incentives. Absent tax incentives, the availability of rental housing would decline and the cost to renters would increase.

Tax policy is of major importance to those who construct housing, to those who finance housing, and, thus, to those who reside in housing. We need a consistent tax policy that maintains our national commitment to affordable, quality housing -- both for home ownership and for rental housing. A consistent policy of support for decent housing and home ownership has been a national commitment for more than fifty years. This principle should be a priority in any tax policy.

Enactment of H.R.3838, as passed by the House of Representatives would have a profound effect upon individuals and businesses, particularly those involved in housing, as well as on home buyers, home owners, and renters. In fact, H.R.3838 represents a fundamental change in the philosophy and objectives of taxation affecting many areas of the economy, and these effects must be weighed carefully before proceeding with tax reform.

H.R.3838 would have an adverse effect on both single-family housing and multifamily housing.

With respect to single-family housing, we are pleased that the House agreed to retain the deduction for State and local real property taxes and the mortgage interest deduction for up to two personal residences. We also are encouraged by the fact that the House agreed to continue the mortgage revenue bond program, at least through 1987. However, we are concerned with the following provisions of H.R.3838, related to single-family housing:

o The bill would repeal the provision of present law that allows construction period interest and taxes to be deducted over a 10-year period. Instead, these amounts generally would have to be recovered over the property's depreciable life (i.e., 30 years for most buildings).

o The bill would reduce the capital gains deduction from 60 percent to 50 percent in 1986 and, further, to 42 percent in 1987. This would increase the top individual income tax rate on capital gains from 20 percent to approximately 22 percent.

o The bill provides special incentives for investment in "very low-income" housing (i.e., projects where at least 40% of the units are set aside for families earning 60% or less of average area median income). However, we are concerned that the definition of very low-income housing may be so restrictive as to render those incentives meaningless.

NAHB estimates that multifamily housing starts would decline by about 50% in each of the first two years after enactment of H.R.3838. (These findings are discussed more fully in Part V.)

In addition, there are other provisions of H.R.3838 that would have an impact upon both single-family and multifamily housing. Two of the most significant of these provisions deal with the individual minimum tax and contributions in aid of construction:

o The bill would increase the top individual minimum tax rate from 20 percent to 25 percent. In addition, it would broadly expand the minimum tax base to include, among other items, certain "passive activity" losses (e.g., limited partnership losses), and interest on tax-exempt nongovernmental obligations (e.g., mortgage revenue bonds and multifamily industrial development bonds).

o The bill would repeal the provision of present law that provides for the treatment of contributions in aid of construction received by public utilities as nontaxable contributions to the capital of the utilities. The effect of this provision would be to cause contributions in aid of construction to be taxable and, thus, to increase the cost of housing through higher costs for infrastructure development (e.g., water and sewer systems).

We also are very concerned about effective dates. Most of the provisions of H.R.3838 would take effect on January 1, 1986, with "grandfather" relief for certain projects underway as of September 25, 1985. Because it is not clear when tax reform legislation will be enacted, we are concerned that the effective dates in the House bill will cause serious disruption in the marketplace and have an adverse impact on investment decisions during 1986. In fact, uncertainty about tax reform already has caused major problems for the tax-exempt bond market. Thus, we urge that the effective date of any final tax reform legislation be no earlier than January 1, 1987, with appropriate "grandfather" rules for projects underway prior to the end of 1986.

Attachment A to this statement summarizes those provisions of H.R.3838 that would have an impact on housing. Attachment B compares the House bill to the original Ways and Means Committee options, the President's proposals, and present law.

II. Single-Family Housing

Several important tax incentives have been established for owner-occupied housing. These include the mortgage interest deduction, the deduction for real property taxes, the deferral of capital gains taxation on the sale of a home, and the one-time exclusion for capital gains of up to $125,000 on the sale of a personal residence for individuals who are age 55 or over.

The President's tax reform proposals would have repealed the deduction for State and local taxes (including real property taxes), and would have sharply limited the amount of interest expense that could be deducted with respect to mortgages on second homes.

The House bill retains full deductibility of State and local taxes. We urge that the Senate bill do likewise. At a minimum, however, we urge the Senate to maintain the deduction for real property taxes. Next to the mortgage interest deduction, the deduction for real property taxes is a key factor in making home ownership affordable.

While the House bill would cut back on the amount of investment interest and consumer interest expenses that could be deducted, it would permit full deductibility of interest on debt secured by the taxpayer's principal residence and on a second home. This provision reflects the belief of the House that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. This provision also recognizes the important role that second homes play in the economies of many communities and the importance of this deduction for middle-income households. We urge the Senate to reaffirm this policy by adopting a provision regarding deductibility of residential mortgage interest that is no more restrictive than the provision contained in the House bill.

Notwithstanding the improvements made by the House to the President's tax reform proposals, we still are concerned with the fact that the House bill would drive up the cost of home ownership, particularly for first-time home buyers. Our primary concerns about the House bill's impact on home ownership stem from the House bill's treatment of mortgage revenue bonds, pledges of installment obligations, and personal exemptions.

Mortgage Revenue Bonds

Mortgage revenue bonds have made housing more affordable by allowing State and local housing finance agencies to convert tax-exempt funds borrowed at low interest rates into mortgages that are typically 2 percentage points or more below the conventional mortgage rate. More than one million low-and moderate-income Americans have bought homes with assistance from the single-family mortgage revenue bond program since the early 1970's.

Since 1980, loans funded by mortgage revenue bonds have been restricted by Federal law generally to first-time buyers of modestly-priced homes. In addition, these loans may be targeted to economically-distressed areas, and most State and local issuers impose income limits.

NAHB was dismayed when the President proposed to repeal the mortgage revenue bond program because it has been an effective means of providing affordable financing to households who otherwise would be unable to achieve homeownership.

We are pleased that the House bill retains mortgage revenue bond financing. However, we feel that the Senate should examine, closely, the changes that are proposed to be made to the mortgage revenue bond program, in order to assure that the program will continue to be workable.

Under present law, at least 90% of mortgage revenue bond ("MRB") proceeds must be used to finance homes of first-time home buyers, and the purchase price of MRB-financed homes may not exceed 110% of the average area purchase price (120% in targeted areas).

The House bill would modify the MRB targeting requirements generally as follows:

o all bond proceeds must be used to finance homes of first-time home buyers;

o the purchase price of MRB-financed homes could not exceed 90% (110% in targeted areas) of the average area purchase price; and

o at least 50% of MRB loans must be made available to borrowers whose family income does not exceed 90% of area median income, and all loans must be made available to borrowers whose income does not exceed 115% of area median income.

In addition, the House bill would subject MRBs to a much tighter volume cap than that under present law, and would allow the MRB program to "sunset" at the end of 1987.

NAHB does not object, in general, to stricter targeting requirements. We agree with the House that there should be standards designed to assure that MRB loans are provided to low- and moderate-income first-time home buyers. However, these standards should not be so restrictive as to undermine the viability of the MRB program.

In particular, NAHB is concerned with the requirement that at least 50% of MRB loans be provided to borrowers whose family income does not exceed 90% of area median income. We are concerned that in times of high interest rates, when MRB financing is needed most, it may be quite difficult, if not impossible, to meet this set-aside requirement. Thus, rather than providing for a national standard that all areas of the country must meet, we would urge the Senate to consider providing the State and local housing agencies with the leeway to provide more flexible income limitations based upon particular housing needs. Most states already have established income restrictions for their MRB programs.

A major problem with the House bill is the volume limitation it would impose on MRBs. Currently, MRBs are subject to a separate annual volume limit that is the greater of 9% of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or $200 million. The House bill would provide a new, unified volume limitation for most so-called "nonessential function" bonds (that is, MRBs, multifamily industrial development bonds, bonds for mass commuting facilities, student loan bonds, small-issue bonds, etc.). Thus, MRBs, which now have their own separate volume cap, would be lumped together with all other competing uses.

The current limit on MRBs, based on recent mortgage lending in each State, reflects the level of housing need. The per capita restriction under H.R.3838 would have very adverse impacts in fast-growing States with large numbers of first-time home buyers.

The annual State volume limitation, under the House bill, would be equal to the greater of (1) $175 per capita (reduced to

$125 in 1988 to reflect the "sunset" of MRBs), or (2) $200 million. A portion of each State's volume limitation ($25 per capita) would be set aside for tax-exempt organizations. Unless overridden by State statute, at least 50% of the portion of each State's annual volume limitation not reserved for tax-exempt organizations would be required to be set aside for housing uses (initially, one-third for MRBs, one-third for multifamily industrial development bonds, and one-third at the State's discretion). Thus, what starts out as a minimal allocation (minimum of $25 per State per capita and maximum of $50 per State per capita) is subject to further cutbacks if other tax-exempt bond uses can more successfully plead their cases at the State level.

We feel that including MRBs in a single unified volume cap would result in a severe reduction of MRB-financed homes, and, thus, would reduce the number of affordably-priced homes for first-time home buyers. According to the Council of State Housing Agencies, the House bill would result in approximately a 47% reduction in MRB activity compared to 1985 levels. We feel that this type of housing policy makes no sense, particularly when you consider the fact that home ownership among young families has been on the decline for the last five years. Since 1980, there has been a 5 percent decline in home ownership for families with heads of household aged 30-35.

Thus, with regard to the volume limitation, because serving the need of moderate-income individuals is an important activity, there should be a separate volume limitation for MRBs.

Finally, because of the worthy goals served by the MRB program, and the need for stability and continuity of housing policy, we urge your consideration of its extension beyond 1987.

Pledges of Installment Obligations

In general, the House bill would provide that when an installment obligation is pledged as security for borrowed money, the borrowed money would be treated as cash received in the year of the pledge.

Simply put, this provision would negate the effectiveness of the homeowner bond (builder bond) program, which has served as a unique tool to address the problem of affordably-priced homes during times of high mortgage interest rates.

Homeowner bonds were developed as a financing mechanism in response to the recession of the late 1970's and early 1980's, which drove about 30% of all home builders out of business. There was a critical need for a new source of mortgage funds, at that time, and homeowner bonds were a private sector response. Homeowner bonds continue to be an important source of capital for the production of affordably-priced homes, primarily for moderate-income home buyers.

Unlike a "traditionally-financed" home sale in which the builder receives cash at closing, under a homeowner bond program, the builder sells homes under the installment method of accounting, receives down payments on the homes, and takes back mortgages on the homes. The builder then receives regular principal and interest payments until the mortgage is retired. Because the builder receives only a portion of the purchase price each year, like any other person who sells on the installment basis, the builder's early year tax liability is lower than for the traditionally-financed builder. However, the builder who uses the installment method of accounting will pay greater taxes in later years as the installment payments are received.

Builders who use homeowner bond financing use the mortgages on homes they have built and sold as collateral for bonds that are issued to obtain capital for additional home construction. Builders then take back the mortgages on these new homes and use them as collateral for future bond issues. The proceeds of these future issues are, in turn, used to provide financing for additional homes. Interest on homeower bonds, unlike mortgage revenue bonds, is fully taxable to the holders of the bonds.

Homeowner bonds have allowed home builders to tap directly into the national capital markets to provide home buyer financing. The development of homeowner bonds has led institutional investors to show an unprecedented willingness to channel their capital into housing. In addition, because of the builder's direct access to major credit markets and through the use of the installment sale method of accounting, builders can provide affordably priced and financed housing through the use of homeowner bond financing.

Studies have demonstrated that homeowner bond financing can save buyers more than a full percentage point in the interest rate. A saving of only 1% on a 30-year mortgage on an $80,000 home will produce savings of nearly $25,000 over the life of the mortgage. While many home owners pay off their mortgages over the full term of the mortgage, the average 30-year mortgage is paid off in 12 years.

For a buyer of an $80,000 home, which is paid off in 12 years, a 1% reduction in interst rates produces nearly $9,000 in savings.

While homeowner bond financing is not restricted, specifically, to moderate-income, first-time home buyers, it has been used primarily by large volume builders offering FHA and VA loans. (Small- and medium-sized builders, who do not have adequate size to issue the bonds themselves, are able to use this financing mechanism by pooling their mortgages together in a cooperative manner.) First-time homebuyers in the $18,000 to $40,000 income range have benefitted the most from homeowner bond financing. Moreover, the majority of the homes built under the homeowner bond program cost $80,000 or less, a price range typically available to first-time home buyers.

Although the House bill's treatment of pledged receivables would have a drastic impact on homeowner bonds, the issue goes far beyond that. With an exception for notes payable within a 9-month period, the bill essentially would tax borrowed money if the borrowing is secured by the pledging of an installment obligation. It is one thing to tax the sale of an installment note. In that case, something of value has been exchanged for cash or other valuable consideration. However, in the case of a pledge, there has been no exchange. Rather, something of value merely has been pledged in order to secure a loan. Borrowed money never has been taxed under our legal system because of the borrower's underlying obligation to repay the principal, as well as interest, over time.

If this provision is enacted, we wonder how long it will be before other types of borrowing are taxed. For example, how long will it be before some fertile mind decides to tax home equity loans on the theory that a homeowner has exchanged the equity in his home for cash? The next "logical" step, of course, would be simply to tax borrowed money without having to resort to the theory of an exchange or a pledge to support taxation.

The House bill goes beyond attacking direct pledges of installment obligations. It also brings within its ambit certain "indirect pledges." Under the House bill, an installment obligation is treated as pledged as security for indebtedness if it is reasonable to expect that the lender took into account payments on the installment obligation as a source for any portion of the payments required on the indebtedness. This provision will be troublesome for any business that sells products over a term longer than 9 months, that does not have substantial assets other than installment obligations, and that is not highly liquid.

We urge the Senate to examine this provision very carefully. It does not just affect home builders who use homeowner bond financing, it potentially affects all businesses involved in other than cash sales.

Because of the provision's impact, and due to the dangerous precedent it would establish, we hope that the Senate will not include this provision in its tax reform bill. However, if there is a revenue concern, there are several options available. For example, a small "excise" tax could be imposed on gross installment sales. Alternatively, the tax deferral available through installment sales could be reduced somewhat. NAHB would be pleased to work with the Senate to explore these and other possible sources of revenue.

Personal Exemptions

The House bill would provide a $2,000 personal exemption for each individual, individual's spouse, and each dependent. However, for individuals who itemize deductions, the bill would impose a floor under itemized deductions equal to $500 times the number of personal exemptions claimed. The practical effect of this provision would be to provide itemizers with a personal exemption of $1,500 and nonitemizers with a personal exemption of $2,000.

Since most itemizers are homeowners, we feel that this provision would discriminate against homeowners and, at least indirectly, discourage home ownership. Thus, we urge that at whatever level the Senate decides to fix the personal exemption, it be the same for all taxpayers whether or not they itemize deductions.

III. Multifamily Housing

Tax incentives attracting investment capital have been the lifeblood of the rental housing market, which serves one third of all American households, including the poor who cannot afford to own their own homes. Without tax incentives to encourage the private sector to build rental housing, the Federal Government's obligation to assist low-income Americans in obtaining housing would have to be far greater than it is today.

The taxation of investment in rental housing is complex. Different provisions in the Internal Revenue Code affect a variety of participants in the development process: developers, builders, and investors. The major tax provisions that have affected rental housing include:

o The accelerated cost recovery system (ACRS depreciation).

o Rehabilitation tax credits.

o Capital gains exclusion.

o Forms of ownership that allow for "flow-through" taxation as a way to attract capital.

o Exemption from the "at-risk" rules.

o 10-year amortization for construction period interest and taxes.

o Tax-exempt industrial development bonds for multifamily housing.

The House bill made several improvements to the President's tax reform proposals in the area of multifamily housing. For example, the House bill retains the rehabilitation tax credit and the provision allowing 60-month amortization for low-income housing rehabilitation expenses, with some modifications. Because of the importance of these provisions in revitalizing our nation's cities, we urge the Senate to follow the lead of the House.

Furthermore, the House bill retains capital gains treatment for sales or dispositions of buildings, retains the present law recapture rules, and retains a partial at-risk exemption for real estate activities.

Clearly, the preservation of capital gains treatment for buildings is crucial. Without it, the price for selling a building would be so high that many investors would be discouraged from investing in the first place. Moreover, it would create somewhat of an anomolous situation to treat the sale of a building as taxable at ordinary income rates while the underlying land would qualify for capital gains treatment.

Almost as important as preserving capital gains treatment for buildings is the preservation of the present law recapture rules. Under those rules, gain on the sale of a building is treated as ordinary income to the extent that accelerated depreciation deductions exceed the deductions that would have been allowable under the straight-line method. Under the President's proposal, all prior depreciation deductions (even if the straight-line method is used) would have to be recaptured. Thus, due to the price that would have to be paid on the back end, many investors would not invest in the first place.

Finally, the House bill is superior to the President's tax reform proposals in that it retains tax-exempt bond financing for multifamily housing, and it provides additional incentives for investment in low-income housing (but not for investment in residential housing generally). However, there are problems, discussed below, with both of these provisions.

Notwithstanding the fact that the House made some improvements to the President's tax reform proposals, there are still major problems concerning depreciation deductions, multifamily industrial development bonds, deductions for "nonbusiness interest," and construction period interest and taxes. These, and other problems, are discussed below.

NAHB is concerned that the changes in the current tax law rules proposed by the House bill would severely disadvantage investment in rental housing compared to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. One need only look to the Deficit Reduction Act of 1984 for evidence of this. Among the many significant items in DEFRA affecting real estate investments were provisions that:

o Increased the recovery period for real property (other than low-income housing) from 15 years to 18 years;

o Imposed immediate recapture of depreciation in installment sales;

o Restricted issuance and use of industrial development bonds;

o Expanded the original issue discount rules to cover sales of property;

o Limited deductions of start-up costs for new ventures;

o Severely restricted the benefits from "privatization" of real property;

o Imposed higher test and imputed interest rates on transactions involving deferred payment sales of property;

o Expanded the rules relating to amortization of construction period interest and taxes; and

o Eliminated tax-free exchanges of partnership interests, and tightened up generally in the area of partnership taxation.

Depreciation deductions

From an investment point of view, rental housing often has been unattractive. Intensive management is necessary both to maintain rental housing and to assure a steady stream of income. The cost of maintenance of rental property has increased considerably in recent years. Furthermore, income generated from rental property is lower than for other types of property.

Residential rents generally do not provide for CPI inflation increases, and the income of residents can support only a certain level of rent. Accordingly, market rents generally do not create an income stream that is competitive with other types of investments. Moreover, rent controls in many jurisdictions have kept rents at below market levels.

These are the reasons that residential housing must retain generous depreciation allowances in order to be competitive with other types of investments. A major reduction in present depreciation allowances would drive capital away from residential housing at a time when more, rather than less, capital is needed.

In 1981, NAHB supported ACRS depreciation because of its certainty and simplicity. However, it is a misconception to believe that ACRS significantly increased depreciation deductions for new residential construction. In fact, under the law prior to the 1981 Tax Act, component depreciation plus the ability to use the double declining balance method of depreciation sometimes provided a more advantageous depreciation situation for new housing than was the situation after ACRS. Component depreciation often provided larger total depreciation deductions over the first six years than does ACRS.

The House bill would substantially alter depreciation allowances for rental property by replacing ACRS with the so-called Incentive Depreciation System ("IDS"). Under IDS, the recovery period for most buildings would be increased from 19 years to 30 years. In addition, the only depreciation method allowable for most buildings would be the straight-line method.

A simple example will help to illustrate the impact of this proposed change for most buildings. Using the Treasury Department's 9 percent discount rate, and assuming a sale after 12 years, the present value of depreciation deductions under the House bill (30-year, straight-line) are reduced by about one-half from present law (19-year, 175% declining balance). Assuming a $1,000 cost basis, the present value of the depreciation deductions under current law is $458. The present value of those deductions under the House bill would be only $236. The present value of the tax savings from depreciation deductions, assuming a 35-percent tax rate, would be $160 under current law (i.e., $458x.35) and only $83 under the House bill (i.e., 236x.35).

We are pleased that the House bill, at least, provides an additional incentive for investment in low-income housing. Under the bill, low-income housing would also be depreciated over a 30-year period, but use of the double declining balance would be permitted. Thus, the depreciation allowance would be about 25 percent more generous than depreciation for other structures. Low-income housing eligible for this method of depreciation would be projects that are financed with industrial development bonds or projects which meet the industrial development bond targeting requirements described below.

The House bill also carves out for special treatment so-called "very low-income housing." That type of housing would be assigned a 20-year recovery period and could be depreciated under the double declining balance method. Thus, the depreciation deductions would be about 50 percent greater than depreciation deductions for rental housing that does not qualify as low-income housing.

In order to qualify as very low-income housing, at least 40 percent or more of the units must be occupied by households whose income is 60 percent or less (for a 4 person household) of median gross income. While we are pleased that the House bill recognizes the need to provide an additional incentive for investment in very low-income housing, we are troubled by the fact that the extent of the extra incentive is probably not adequate to stimulate construction for the very low-income group, without the provision of additional, direct subsidies.

Beginning in 1988, the House bill would provide a partial inflation adjustment for IDS deductions. In general, IDS deductions would be increased by one-half of the inflation rate in excess of 5 percent. We recognize that this provision would provide taxpayers with at least some protection against loss of real value in depreciation deductions due to excessive inflation. However, we would suggest that the same goal could be accomplished, with greater simplicity, by providing shorter depreciable lives.

With regard to depreciation, we would urge the Senate to adopt a system which compensates for the risk of investing in residential rental property. Furthermore, we would urge that the Senate provide an additional incentive for low-income housing that will not require direct subsidies to make investment in such housing feasible.

Industrial Development Bonds for Multifamily Housing

Even though current tax law provides several incentives for investment in rental housing, it generally is not feasible to construct new rental housing for low-and moderate-income households at rents they can afford, given current costs and interest rates. In recent years, virtually new rental housing for low-and moderate-income households has been financed with state and local industrial development bonds ("IDBs") often in tandem with Federal rent subsidies. These IDBs provide debt financing at rates that are 200 basis points or more below conventinal mortgage rates.

In 1984, IDB financing of rental housing totaled about $5 billion and provided financing for about 100,000 new rental units, accounting for about 25% of new rental units in structures of 5 or more units. For 1985, total IDB financing was in the neighborhood of $11 billion, accounting for about 200,000 units or approximately 50% of rental units in structures with 5 or more units.

In order to qualify for tax-exempt IDB financing for multi-family housing, at least 20 percent of the housing units must be set aside for tenants with low-or moderate-income. However, for certain targeted area projects, this set-aside requirement is reduced to 15 percent. A targeted area is a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or an area of chronic economic distress. The set-aside requirement must be satisfied continuously during the qualified project period (generally, a minimum of ten years).

The determination of whether individuals qualify as low-or moderate-income individuals is made by reference to the rules under section 8 of the Housing Act of 1937 for determination of lower-income families, except that the percentage of family median gross income that qualifies as low or moderate is 80 percent.

Until this year, there was no requirement in Treasury Regulations that adjustments in family size had to be made in the applicable percentage of median gross income to determine whether a multifamily IDB qualifies for tax exemption. However, this is now a requirement for IDBs issued after December 31, 1985.

Bonds that are issued to finance multifamily residential rental property are under fewer restrictions than apply to other types of IDBs. Multifamily IDBs are not subject to the state volume limitations that were placed on other tax-exempt private acitivity bonds in the Deficit Reduction Act of 1984. IDBs for multifamily housing also received exceptions from other restrictions placed on IDBs by the Deficit Reduction Act of 1984, including additional arbitrage restrictions, a prohibition on Federal guarantees of tax-exempt bonds, and a requirement that cost recovery deductions be determined using the straight-line method rather than full ACRS deductions.

The more liberal treatment accorded multifamily rental IDBs vis-a-vis other tax-exempt bonds reflects the important public purpose served by tax-exempt rental financing.

IDB financing has become a real necessity to the rental housing market in this era of high real and marginal interest rates. Using the NAHB computer model of an investment in rental housing, we estimate that IDB financing permits a project to "pencil out" or be economically feasible at rents which are 12 percent lower than with conventional financing. These lower rents are translated into below-market rents on set-aside units for qualifying households, generally lower rents and greater availability of moderate income housing, or into meeting special targeting goals of the state or local housing finance agency.

Absent tax incentives, a large portion of the nation's substantial demand for rental shelter would go unmet. As it is, renters' shelter costs have risen significantly over the past decade. According to the Census Bureau and HUD, the cost of rent, utilities, and fuel accounted for 29 percent of renters' median family income in 1983, up from 22 percent in 1973.

The House bill would make several significant changes to multifamily IDBs. First, the targeting requirements would generally provide the following:

o 25 percent or more of the IDB-financed units must be rented to families whose income is 80% or less of area median income, adjusted for family size, or

o 20 percent or more of the units must be rented to families whose income is 70 percent or less of area median income, adjusted for family size.

Second, the project operator would have to certify annually to the Treasury Department that the project is in compliance with the targeting requirements. Failure to comply with the set-aside requirements would result in loss of tax-exemption for interest on bonds used to finance the project, retroactive to the date of their issuance. In addition, failure to correct noncompliance with the set-aside requirement would result in the nondeductibility of interst on bond financed loans. Failure to make the required annual certification would result in a penalty of $100 per failure.

Finally, the House bill would subject multifamily IDBs to a single, unified volume cap, along with all other so-called "non-essential function bonds." As noted above, multifamily IDBs are not subject to any volume restriction under present law. The House bill's volume limitation is discussed above in connnection with mortgage revenue bonds.

NAHB does not quarrel with the stricter targeting (set-aside) requirements that would be imposed by the House bill. In fact, when we testified last summer before the Subcommittee on Oversight of the House Ways and Means Committee, we suggested the possibility of stricter targeting, provided that such stricter targeting would not destroy the economic viability of the multifamily IDB program. We do not think that the targeting in the House bill is so strict as to do so. Furthermore, we would urge the Senate to adopt the provision of the House bill that provides that a qualified low- or moderate-income tenant is treated as continuing to be such notwithstanding de minimis increases in his or her income. Under that provision, if a family qualified as having low- or moderate-income when initially occupying a housing unit, that family will be treated as continuing to have such an income as long as its family income does not increase by more than 20%. In addition, we would ask the Senate to look favorably upon the House Ways and Means Committee Report language providing that tenants need not be evicted to return a project to compliance.

However, with regard to the family size adjustment requirement of the House bill, NAHB recommends the following:

o Consideration should be given to an adjustment system based on other than section 8 income adjustment factors, because those factors are not geared specifically to IDB-financed projects. The direct subsidy provided in the section 8 program enables incomes, adjusted for family size, to support higher rents than would be affordable if rents were based only on the incomes of the renters. If an adjustment system based on section 8 affordability standards is applied to IDB-financed projects, the resulting income limits may result in rent levels that, in many cases, would be too low to support new construction. The application of section 8 adjustment factors would be particularly problematic in low-income areas.

o The family size adjustment system should be tied to rental unit sizes so that rents could be determined in advanced for purposes of project planning and underwriting.

o A family of three, rather than a family of four, is the appropriate base for family size adjustments. Since 1965, the average family size has declined steadily and stood at 3.23 in March 1985.

o The separate, not combined, income of individuals sharing housing expenses should be considered when qualifying renters for set-aside units.

o Any system of family size adjustment should be tied to current income targeting restrictions for residential rental IDBs.

With regard to the annual certification requirements, we can understand the concern of the House that projects which are financed with multifamily IDBs should meet the set-aside requirements on a continuing basis. However, we are concerned about the added administrative costs this will impose upon project operators. We would suggest that the Senate consider less costly methods of compliance. It may be that periodic certifications on less than an annual basis (perhaps every 3 or 4 years) would accomplish the same results.

A major problem with the House bill is the new annual volume limitation. Multifamily IDBs, which are not now subject to a volume cap, would be lumped into a single, unified volume cap along with most other permissible uses of IDBs. Because of the worthy social goals served by multifamily IDBs, we would urge that they not be subjected to a volume restriction. According to data prepared by the Council of State Housing Agencies, if the volume limitation became effective this year, it would result in about a 21%-45% reduction in multifamily IDBs compared to 1985. If multifamily IDBs are to be limited, we would urge, at a minimum, that the Senate impose a separate cap for them, and that the cap be based on a measure of housing need or construction activity rather than on a per capita basis.

Interest deduction limitations

Under present law, investors in real estate activities generally are not limited as to the amount of interest they may deduct because they are considered to be involved in a trade or business activity. The House bill would sharply restrict the deduction for interest expense attributable to a "limited business interest." A limited business interest would include the following:

o An interest as a shareholder of a subchapter S corporation in whose management the taxpayer does not actively participate;

o An interest as a limited partner in a partnership; and

o An interest in an enterprise as a limited entrepreneur who does not actively participate in the management of the enterprise.

The deduction for interest expense attributable to a limited business interest, along with all consumer debt, would be limited to $10,000 per year ($20,000 on a joint return) plus the amount of a taxpayer's net investment income.

Many multifamily developments are structured in the form of limited partnerships in order to attract the neeeded capital. Without the ability of investors to deduct all interest incurred on debt necessary to finance a development, we are concerned that new construction of multifamily housing will suffer.

In addition, we are concerned that the provision would add further complexity to the Internal Revenue Code, and result in additional administrative disputes. For example, we can envision endless disputes over what amounts to "active participation" in management.

Finally, we are concerned with the potential retroactive impact of this provision, since it would apply to interest paid or incurred after January 1, 1986. Even though the effective date is ameliorated somewhat by a 10-year phase in, it could, in certain situations, apply to individuals who incurred debt well before 1986.

While we can understand the need for some curb on consumer debt, we urge that interest paid or incurred with respect to housing be excepted from any limitation. Furthermore, if the Senate does adopt a limitation, we urge, at a minimum, it except interest with respect to very-low income housing and IDB-financed projects. In addition, if the Senate does impose an interest deduction limitation, we strongly urge that it have no retroactive impact (i.e., it should apply only to debt incurred after a fixed date).

Construction period interest and taxes

Until 1976, construction period interest and taxes were deductible currently. Present law requires construction period interest and taxes for most buildings to be amortized over a 10-year period.

Under the House bill, interest on debt incurred or continued to finance the construction of buildings must be capitalized, if the property is used by the taxpayer in its trade or business or an activity for profit. Thus, construction period interest for most buildings would be added to the cost basis of a building and recovered pro rata over a 30-year period.

Interest expense is a significant component of long-term construction costs. Because of this, the direct impact of the House bill would be to increase the cost of construction. Thus, we would urge that residential buildings be excepted from the capitalization requirements. Furthermore, because of the increased risks associated with low-income housing, we urge that the present law provision allowing current deductibility for construction period interest and taxes related to low-income housing be retained.

Capital gains deductions

As previously noted, NAHB is pleased that the House did not adopt the President's proposal to deny capital gains treatment for buildings. To deny capital gains treatment for buildings would have been a serious detriment to investment in multifamily housing.

The House bill, instead, increased the top capital gains tax rate for individuals from 20 percent to approximately 22 percent. We believe that capital gains should continue to enjoy the same relative advantage as under present law. However, our paramount concern is that buildings continue to qualify for capital gains treatment when sold or exchanged.

Extension of at-risk rules to real estate activities

Under present law, real estate activities are exempt from the at-risk rules which apply to most other types of investments. Thus, investors in real estate limited partnerships are able to deduct losses in excess of actual cash invested, and loans for which they are personally liable, because they are entitled to share in "nonrecourse" liability. The present law at-risk exception makes sense, because lenders to real estate activities generally look only to the value of the property securing the loan in the case of default.

In general, the House bill would extend the at-risk rules to real estate activities. However, qualified nonrecourse financing in a real estate activity would continue to be exempt from the at-risk rules.

Qualified nonrecourse financing would include financing that is secured by real property used in the activity and that is (1) loaned or guaranteed by a Federal, State, or local government, or (2) borrowed by the taxpayer from a "qualified person," provided that such amounts are not used to acquire an interest in property from a related person.

A qualified person generally would be any person who is actively and regularly engaged in the business of lending money. However, a qualified person could not be (1) any person related to the taxpayer; (2) any person from which the taxpayer acquired the property; or (3) any person who receives a fee with respect to the taxpayer's investment in the property.

Essentially, the House bill would limit the at-risk exception to third-party debt from a financial institution. We can understand the purpose of this limitation from the standpoint of the concerns related to potential overvaluation of property for the purpose of "inflating" basis. However, we feel that the limitation in the House bill goes too far in that it would seem to deny the at-risk exception in the case of legitimate joint venture arrangements that do not involve potential overvaluation problems. Thus, we believe the Senate should clarify that joint venture arrangements between taxpayers and "qualified persons" (for example, banks, savings and loan associations, and insurance companies) are within the scope of the "qualified nonrecourse financing" exception. Furthermore, we believe that clarification is needed to provide that certain types of guarantees (e.g., mortgage guarantee insurance) will not cause financing to be treated as other than qualified nonrecourse financing.

IV Other Provisions

There are several other provisions in the House bill that would have an adverse impact upon both single-family housing and multifamily housing. Two of these provisions with which NAHB is particularly concerned deal with the proposed changes to the individual minimum tax, and the treatment of contributions in aid of construction.

Individual minimum tax

The House bill would increase the minimum tax rate from 20 percent to 25 percent. In addition, it would substantially broaden the minimum tax preference base, and revise certain existing tax preferences.

The rationale for the minimum tax is that all individuals and corporations should pay their fair share of tax, without regard to the preferences to which they are entitled for purposes of the regular tax. NAHB does not quarrel with the purpose intended to be served by the minimum tax. In fact, NAHB has existing policy to the effect that all individuals and corporations should pay their fair share of tax. However, we are concerned that the House bill amounts to "overkill" and would drastically undermine the incentive to invest in housing.

The House bill would add two new preferences which we find particularly troublesome insofar as the impact they will have on investment in housing. These are (1) tax-exempt interest on "nonessential function" bonds, and (2) excess passive activity losses.

For purposes of the minimum tax (corporate, as well as individual) tax-exempt interest on nonessential function bonds would be treated as a preference item. Thus, the preference would include interest on tax-exempt mortgage revenue bonds and interest on multifamily IDBs. Because such interest would be a preference item, investors would be much less likely to invest in MRBs and multifamily IDBs. This will raise the interest cost on such issues and have a direct impact on the number of affordably-priced single-family homes and moderate-income multifamily units that are constructed.

Under the House bill, any excess passive activity loss of an individual, to the extent not already denied for minimum tax purposes, would be treated as a preference.

An excess passive activity loss would be an amount equal to the amount by which the aggregated losses for the taxable year from all passive activities exceeds the aggregate income from such activities for the year. This amount would be reduced by certain cash basis of the taxpayer in passive investment activities. However, the amount of cash basis that the taxpayer could take into account with respect to all tax shelters could not exceed $50,000 annually.

An activity would be excluded from treatment as a passive activity if the taxpayer materially participates in the activity or provides substantial personal services for the activity.

We are concerned that the "excess passive activity loss" preference will have a serious adverse impact upon investment in multifamily housing. As noted above, limited partnerships are a common vehicle for investment in multifamily housing. The fact that investors would not be able to utilize, fully, the losses incurred through limited partnership investments would seriously undermine the incentives for investing in multifamily housing. Furthermore, the "cash basis" limitation would seriously undermine the benefit of retaining at least a partial at-risk exception for real estate activities.

We are also concerned with the manner in which the depreciation preference would be computed. Under present law, accelerated depreciation on real property is a preference only to the extent that it exceeds depreciation that would have been allowed under the straight-line method. Under the House bill, depreciation for most buildings would be a preference to the extent that depreciation over a 30-year period under the straight-line method exceeds depreciation over a 40-year period under the straight-line method.

We urge that, as under present law, only the excess of accelerated depreciation over straight-line depreciation should be treated as a preference item.

By raising the minimum tax rate, the House bill greatly reduces the spread between the minimum tax rate (25%) and the top individual income tax rate (38% under the House bill). This, by itself, would be enough to sharply cut back on incentives for investing in housing. If the base for the minimum tax is to be broadened as much as the House bill proposes, we urge that the spread between the minimum tax rate be kept in parity with the spread in those rates under current law (i.e., 20% minimum tax rate versus a 50% top individual income tax rate).

Finally, we are troubled with the retroactive implications of the effective date. The minimum tax would be effective for taxable years beginning after December 31, 1985. This is a particular problem with respect to the proposed new preference for excess passive activity losses. Individuals who took advantage of legitimate tax incentives in prior years could now find themselves subject to the minimum tax. We trust that the Senate will cure this potential inequity.

Contributions in aid of construction

Under present law, contributions in aid of construction received by a public utility company are treated as nontaxable contributions to the capital of the utility. The House bill would treat contributions in aid of construction as taxable income to the utility.

The effect of this provision would be to raise the cost of housing through higher costs for infrastructure development (e.g., water and sewer systems). In fact, we are already aware of situations where utility companies are demanding higher fees from developers in anticipation of the eventuality that they will have to include such fees in their taxable income. Based upon information we have gathered to date, some utility companies are demanding as much as a 60% fee increase.

We urge the Senate to reaffirm the present law treatment of contributions in aid of construction as nontaxable contributions to capital rather than payments made in anticipation of services to be rendered.

V. Economic Impact

Single-family housing

In the case of single-family housing, the reduced personal exemption for taxpayers who itemize deductions, the increase in the standard deduction, the reduction in the deductibility of miscellaneous expenses, and the change in tax rates would all reduce the tax incentive for homeownership. The effect on the after-tax cost of homeownership for a typical middle-income first-time homebuyer would be equivalent to the impact of an increase in mortgage interest rates of about 1.5%. Normally, an increase in mortgage interest rate of that mangitude would reduce single family starts by about 150,000 units. Taking into account the differential effect on mortgage qualification criteria and other mitigating factors, we conservatively estimate that this change would cause a reduction in single family housing starts of about 75,000 units in the first year after enactment. The second year impact would be about equally large. After a few years, pent-up demand and the likely increase in rents will bring the level of single family starts back to the levels that would have occurred under a continuation of current law.

The volume limits on MRBs will have an adverse impact on starts in areas of strong housing demand, contributing another 20,000 units to the first year reduction. The installment sales provision will cost another 15,000 starts. Thus, total reduction in single family starts in the first year after enactment would be about 110,000 units.

Multifamily housing

In the multifamily sector, the adverse impact of H.R.3838 would be relatively much greater. The changes in depreciation, the treatment of construction period interst and taxes, and the changes in tax rates would lower the after tax return to investors in rental housing. In order to provide the same after-tax return to investors, a typical newly constructed apartment renting for $421 under current law would have to rent for $524 under H.R.3838, assuming no change in development costs or interest rates. The additional impact of the limitation on interest expense deductions for non-active partners and the categorization of losses from passive investments as preference items would significantly restrict the flow of capital to rental housing and further raise the rent required to make new construction feasible.

Actual rents are determined by the interaction of demand with the supply of rental housing. Since new construction accounts for only a very small share of total housing supply in the short run, the impact of an increase in the rents required to justify new construction would not be an immediate increase in rents. Instead, the short term result would be a sharp drop in new rental construction and in the resale value of existing properties. The impact on resale values would naturally be reflected in poorer maintenance and accelerated abandonment of existing structures. Over time, the lack of new construction and the deterioration of the existing stock would be reflected in higher rents. After a period of several years, rents would rise to the point where new construction would again be feasible to the same extent as would be true under a continuation of current law.

Even though it may take 5 to 10 years for the increase in required rents to be fully reflected in actual rents, the partial rent adjustments in the first few years will more than offset the savings due to tax reform for most low-and moderate-income renter households. That is because such households devote a much larger share of their incomes to rent than to Federal income taxes.

It is hard to estimate the impact of the changes in the taxation of rental housing on construction activity, because the extent of the changes is so drastic that it is hard to imagine any new development being feasible. However, experience has shown that even under the most adverse circumstances some new construction usually occurs. We expect that the net effect on multifamily housing starts will be a reduction of about 50%, or about a quarter of a million starts, in each of the first two years. The net reduction relative to a continuation of current law would gradually fall as rents rose and vacancy rates became very low, so that by the fifth year, the net difference would disappear.

Another way of looking at the impact of the tax changes is in terms of the equivalent change in interest rates. The impact on returns to equity investors would be similar to an mortgage interest rate increase of 4% to 5%.

For rental properties that, for whatever reason, are financially shaky, a decline in resale values increases the attraction--and therefore the likelihood--of default on the mortgage. Since a non-recourse mortgage loan is effectively an option to sell the property to the lender for the outstanding loan balance, a decline in market resale values may make the lender the involuntary high bidder for distressed properties. Thrift institutions hold roughly half of conventional multifamily mortgages, and many of the most unsound thrift institutions have been among the most aggressive lenders to dubious rental housing investments, so there could be a rather severe impact on the thrift industry and the Federal insurance funds.

VI. Conclusion

The provisions of H.R.3838 that have an effect on housing are of great concern to the membership of NAHB. They will increasingly become a concern of homeowners and renters alike when these impacts become more widely known and understood.

We agree that tax reform may be needed to assure that all taxpayers, both corporations and individuals, pay their fair share of tax. However, we strongly believe that the following principles should guide any major revision of the nation's tax laws:

o First, tax reform should enhance economic growth, savings and investments ... not retard them.

o Second, tax reform should be revenue neutral or revenue positive... certainly not creating a revenue loss which only adds to the Federal deficit.

o Third, tax reform should be fair and not disproportionately affect one industry or group of individuals at the expense of another.

o Fourth, tax reform should not erode the national commitment to homeownership and affordable rental housing.

o Fifth, tax reform should be accomplished in a manner which provides an orderly transition to the new rules. Effective dates should be prospective so that individuals and businesses can plan with certainty.

As the Senate proceeds with the task of rewriting the tax code, we urge you to consider the fact that there has been a major reduction in direct Federal housing spending over the past several years, particularly for low-and moderate-income people and the elderly. This has left the tax code as the cornerstone of national housing policy. The decisions you make on this proposal to a great extent will affect the production of housing, the rents paid for housing, and even the value of housing.

On the question of timing, we urge the Senate to complete serious action on the national deficit problem, before consideration of tax reform.

Finally, we urge the Senate to keep in mind that housing is a significant national interest and an important national priority.

Attachment A

House Bill
Decisions Affecting Housing

Prepared by Government Affairs Division

Single-Family Housing

State and local tax deductions

State and local taxes would remain fully deductible.

Mortgage Revenue Bonds

MRBs for single family housing would be continued through 1987, with the following new restrictions:

- o all bond proceeds must be used to finance homes of first-time homebuyers;
- o the purchase price of MRB-financed homes could not exceed 90 percent (110 percent in targeted areas) of the average area purchase price; and
- o all MRB loans must go to borrowers whose family income does not exceed 115 percent of area median income (with at least 50 percent of loans going to borrowers whose family income does not exceed 90 percent of area median income).

MRBs would be included in a $175 per capita per State volume cap, along with multifamily IDBs and other nongovernmental ("private purpose") bonds.

Second homes

Taxpayers would be permitted to deduct nonbusiness interest on debt secured by up to two residences, without limit.

Homeowner bonds

The proceeds of a loan for which an installment obligation is pledged would be treated as payment on the pledged obligation, and a proportionate amount of deferred gain would be recognized at the time of the pledge. The provision would be phased in over a three-year period. For homeowner bonds issued in 1986, income would be recognized over a three-year period. For bonds issued in 1987, income would be recognized over a two-year period. The provision would be fully effective in 1988.

Energy Conservation Credit

The 15-percent energy conservation credit for residences would expire at the end of 1985.

Solar Energy Credit

The solar energy credit for residences would be extended through 1988 for the first $10,000 of renewable energy property. The credit rate would be 30 percent in 1986 and 20 percent in 1987 and 1988.

Multifamily Housing

At-Risk Rules

Third-party financing for real estate would be exempt from the at-risk rules.

Interest Limitations

The deduction for nonbusiness interest would be limited to the sum of:

- o Interest on debt secured by up to two residences;
- o net investment income; and
- o $10,000 ($20,000 on a joint return).

There would be no interest limitation for investments in very low-income housing or IDB-financed projects.

Depreciation

- o Very low-income housing (40/60 set aside)-20 years/200 percent declining balance.
- o Moderately low-income housing (25/80 or 20/70 set aside, whether or not IDB financed)-30 years/200 percent declining balance.
- o Other buildings-30 years/straight line.

Recapture

Present law (i.e, excess of accelerated depreciation over straight line).

Inflation Adjustment

Basis of depreciable property would be indexed for 50 percent of inflation in excess of 5 percent..

Capital Gains

42 percent exclusion (buildings included). (50 percent exclusion in 1986.)

Multifamily IDBs

Multifamily IDBs would be retained, but with stricter targeting and other new requirements.

Multifamily IDBs could be issued if:

- o 25 percent or more of the units are rented to families whose income is 80% percent or less of area median income, adjusted for family size, or
- o 20 percent or more of the units are rented to families whose income is 70 percent or less of area median income, adjusted for family size.

IDB proceeds would have to be used for rental housing for the longer of 15 years or the maturity date of the bonds with the longest term.

The project operator would be required to certify annually that the project continues to meet the low-income set-aside rules. For purposes of certification, a tenant's income could increase by up to 20 percent.

Multifamily IDBs would be included in a $175 per capita per State volume cap, along with MRBs and other nongovernmental bonds. The cap would drop to $125 per capita in 1988 to reflect the "sunset" of MRBs.

Rehabilitation Tax Credit

The rehabilitation tax credit would be maintained in a modified form. The credit would be 10 percent for buildings constructed before 1936 and 20 percent for historic structures.

Construction Period Interest

The provision allowing 10-year amortization of construction period interest and taxes would be repealed. Thus, construction period interest would be capitalized and recovered through depreciation. Real property taxes would be capitalized under the rules for long-term contracts.

Long-Term Contracts

The completed-contract method of accounting would be repealed for large contractors. Instead, a modified percentage-of-completion method would be required for contracts entered into on or after September 25, 1985. However, contractors with average annual gross receipts of $10 million or less for the three preceding taxable years could continue to use the completed-contract method of accounting for long-term construction contracts lasting less than two years.

Low-Income Housing Rehabilitation Expenditures

Up to $30,000 of expenditures for rehabilitation of a low-income housing unit could be amortized over a 60-month period.

Other Items

Individual Rates

The top rate would be 38 percent. The personal exemption would be $2,000 ($1,500 for itemizers).

Individual Minimum Tax

The minimum tax rate would be increased to 25 percent. New preference items, for purposes of the minimum tax base, would include interest on tax-exempt IDBs and limited partnership losses. Up to $50,000 of losses per year would not be a preference, if the losses reflect cash contributions.

The capital gains rate for the minimum tax would be the same as that for the regular tax.

Charitable contributions of appreciated property would be treated as a preference only to the extent of the taxpayer's other preferences.

Contributions in Aid of Construction

Contributions in aid of construction (*i.e.*, payments by a developer to a utility for infrastructure) would be treated as taxable income.

Corporate Minimum Tax

The minimum tax rate would be increased to 25 percent. Interest on tax-exempt IDBs would be a preference item.

Corporate Tax Rates

The top corporate tax rate would be 36 percent.

Business and Entertainment Expenses

80 percent of business and entertainment expenses would be deductible.

Effective Dates

Most provisions would take effect on January 1, 1986. Certain projects underway as of September 25, 1985, would continue to be governed under present law. Individual rate cuts would take effect on July 1, 1986.

ATTACHMENT B

TAX REFORM PROPOSALS AFFECTING HOUSING

I. SINGLE FAMILY HOUSING

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
A. State and local tax deduction	Individuals can claim itemized deductions for State and local income taxes, real property taxes, personal property taxes, and sales taxes.	The itemized deduction for State and local taxes would be repealed.	Individuals could deduct State and local income and real property taxes to the extent of the greater of: o $1,000, or o the excess of taxes paid over 5% of the individual's adjusted gross income. Effective date-Tax years beginning after 12/31/85.	State and local taxes remain fully deductible.
B. Second-home interest deduction	No limitation.	Deductions for interest that is not incurred in connection with the taxpayer's principal residence or business would be limited to net investment income plus $5,000.	Deductions for interest that is not incurred in connection with the taxpayer's principal residence or business would be limited to net investment income plus the greater of: o interest on debt secured by the taxpayer's principal residence (to the extent of fair market value), or o $20,000. Effective date: Interest paid in tax years beginning after 12/31/85. There would be a 10-year phase-in.	Taxpayers would be permitted to deduct nonbusiness interest on debt secured by up to two residences, without limit. Effective date-Taxable years beginning after 12/31/85.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
C. Mortgage revenue bonds	MRBs must be targeted as follows:	Tax-exemption for MRBs would be repealed.	MRBs would retain tax-exemption, but targeting requirements would be modified:	Same as staff option.
	o at least 90% of proceeds must finance homes of first-time buyers, and o purchase price of homes may not exceed 110% (120% in targeted area) of average area purchase price.	MCCs would be repealed.	o all bond proceeds must be used to finance homes of first-time buyers; o purchase price of homes could not exceed 90% (110% in targeted areas) of the average area purchase price; and o at least 50% of loans must go to borrowers whose family income does not exceed 90% of area median income, and all loans must go to borrowers whose income does not exceed 115% of area median income. (This requirement is liberalized for targeted areas.)	
	Mortgage credit certificates (MCCs) may be issued equal to 20% of each dollar of MRB authority exchanged.		MCCs would be subject to the same targeting requirements.	
	MRBs are subject to a separate, annual volume limit that is equal to the greater of (1) 9% of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million.		MRBs would "sunset" in 1987. MRBs would be included in a single, unified State per-capita volume limit. Effective date: Generally, bonds issued after 12/31/85.	

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
D. Homeowner bonds	If an installment obligation is pledged as collateral for a loan, gain is recognized only as payments on the loan are received.	If an installment obligation is pledged for a loan, the loan proceeds would be treated as payment on the obligation and a proportionate amount of deferred gain would be recognized. If an installment obligation is pledged as collateral for a homeowner bond, the loan would trigger gain to the extent that the loan proceeds exceed the basis of the obligation.	All pledges would be treated as payment on the installment loan and income would be reconized using the gross profit ratio. Effective date-Obligations pledged after 12/31/85 and any obligation created after 9/25/85 if pledged for debt outstanding after 12/31/85. Any installment obligation created before 9/26/85 and pledged before 1/1/86 is treated as pledged on 1/1/91, if still outstanding on 1/1/91.	Same as staff option. Effective date-If an obligation is pledged in 1986, then the ratable portion of the net proceeds of the obligation would be taken into account ratably over a 3-year period. If the obligation is pledged in 1987, it would be taken into account ratably over a 2-year period. (The 1991 date was removed.) Obligations pledged after 9/25/85 and before 1/1/86 would be treated as pledged in 1986.

II MULTIFAMILY HOUSING

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
A. Depreciation	In general, buildings have an 19-year recovery period and may be depreciated under the 175% declining-balance method.	Buildings would be depreciated over a 28-year period, using a 112% declining-balance method.	Most buildings would be depreciated under the straight-line method over a 30-year period.	Most buildings would be depreciated under the straight-line method over a 30-year period.
	Low income-housing has a 15-year recovery period and may be depreciated under the 200% declining balance method.	There would be no disdinction between low-income housing and other buildings.	Low-income housing would be depreciated over 18 years, using the 150% declining-balance method.	Very low-income housing (40% of units set aside for families with 60% or less of median area income) would be depreciated over a 20-year period, under the 200% declining balance method. Moderately low-income housing (housing that meets the IDB targeting requirements, whether or not IDB financed) would be depreciated over a 30 year period, under the 200% declining balance method.
		The basis (cost) of real property would be adjusted upward for inflation.	There would be no basis adjustment.	A partial inflation adjustment (1/2 of inflation in excess of 5%) would become effective in 1988.
	For residential buildings, gain is recaptured to the extent that accelerated depreciation deductions exceed straight-line depreciation. Recapture for low-income housing is phased out after it has been held for a prescribed period. For commercial property, there is full recapture unless the straight-line method was used.	All gain on sale of a building would be treated as ordinary income.	Gain would be recaptured to the extent of previously allowed depreciation.	
			Effective date-Property placed in service after 12/31/85. A transition rule would "grandfather" property that is constructed or purchased pursuant to a contract that was binding as of 9/25/85	

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
B. Recapture of excess depreciation deductions.	No provision	Taxpayers with "excess depreciation" would have to include 40% of the excess depreciation in income over a 3-year period.	No provision.	No provision.
C. Capital gains	Individuals can deduct 60% of long-term capital gains. Thus, the top capital gains rate is 20%.	Individuals could deduct 50% of long-term capital gains. Thus, the top capital gains rate would be 17 1/2%. Buildings would not be entitled to capital gains treatment.	The capital gains deduction would be 40% (for a top rate of 21%). Gain on the sale of buildings would be entitled to the capital gains deduction, but all previous depreciation would be recaptured as ordinary income. Effective date-Sales on or after 1/1/86. Recapture would apply to dispositions of property placed in service after 1985.	50% exclusion in 1986. 42% exclusion in 1987 and thereafter (22% top rate). Buildings would be entitled to capital gains treatment. Present law recapture (i.e., excess of accelerated depreciation over straight line) would apply.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
D. Investment interest limitation	Same as I.B.	Same as I.B.	Same as I.B.	The deduction for nonbusiness interest would be limited to the sum of: (1) interest on debt secured by up to two residences; (2) net investment income; and (3) $10,000 ($20,000 on a joint return). The interest limitation would not apply to investments in very low-income housing or IDB-financed projects. Effective date-Taxable years beginning after 12/31/85.
E. At-risk rules	Real estate activities are not subject to the at-risk rule.	Real estate activities would be subject to the at-risk rule. Thus, losses could be deducted only to the extent of cash invested plus debt for which there is personal liability.	Same as President's proposal. Effective date-Losses with respect to property acquired after 12/31/85.	The at-risk exception would appl to nonrecourse debt from a third party lender.
F. Rehabilitation tax credit	15 percent for 30-year old buildings. 20 percent for 40-year old buildings. 25 percent for historic structures.	Repealed.	10-percent credit for buildings constructed before 1936. 20-percent credit for historic structures.	Same as staff option.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
	For 15 percent and 20 percent credit, depreciable basis is reduced by full credit amount. For 25 percent credit, basis is reduced by 1/2 credit amount.		Full basis adjustment. Effective date-Property placed in service on or after 1/1/86. "Grandfather" for rehabilitation pursuant to binding contracts in effect on 9/25/85.	Same as staff option.
G. 60-month amortization of low-income housing rehabilitation expenditures.	Taxpayers can amortize over a 60-month period certain expenditures for improvement of low-income housing. Eligible expenditures cannot exceed $20,000 (in certain cases $40,000) per unit.	Repealed. Expenditures would be added to depreciable basis.	Retained, with a $30,00 per unit limit. Effective date-Expenditures paid or incurred on or after 1/1/86. $40,000 limit would be "grandfathered" for binding contracts existing on 9/25/85.	Same as staff option. Same as staff option.
H. 10-year amortization of construction period interest and taxes.	Construction period interest generally is capitalized and amortized over a 10-year period.	Construction period interest would be added to depreciable basis.	Same as President's proposal. Effective date-Interest incurred after 12/31/85.	Same as President's proposal.

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	COMMITTEE STAFF OPTION	HOUSE BILL
I. Multifamily IDBs.	Interest earned on IDBs for multifamily housing is tax-exempt. To qualify as multifamily IDB: o at least 20% (15% in targeted area) of housing units must be occupied by persons whose income does not exceed 80% of area median income when they first rent unit; and o must be used for rental housing for 10 years or 50% of term of bonds with longest maturity. There is no volume limitation.	Repealed.	New targeting requirements: o at least 30% (25% in targeted areas) of housing units must be occupied by persons whose income does not exceed 70% of area median income and at least 10% must be occupied by persons whose income does not exceed 50% of median area income (this requirement must be met on a continuing basis); o bonds must be used for rental housing for the longer of 15 years or the maturity date of the bonds with the longest term; and o project operator must make annual certification to Treasury that project is in compliance. All private purpose IDBs would be subject to $175 State per-capita limit (reduced to $100 after 1987). Effective date: Bonds issued after 12/31/85.	Same as staff option, except Multifamily IDBs could be issued if: o 25 percent or more of the units are rented to families whose income is 80% percent or less of area median income, adjusted for family size, or o 20 percent or more of the units are rented to families whose income is 70 percent or less of area median income, adjusted for family size.

III OTHER ITEMS

ITEM	PRESENT LAW	PRESIDENT'S PROPOSAL	WAYS AND MEANS COMMITTEE STAFF OPTION	HOUSE BILL
A. Rate structure	14 brackets, rates varying from 11% to 50%. Zero bracket amount (ZBA) is $3,540 for joint returns. Personal exemption is $1,040.	3 rate brackets: 15%, 25%, and 35%. ZBA increased to $4,000 for joint returns. Personal exemption increased to $2,000.	3 rate brackets: 15%, 25%, and 35%. ZBA converted to standard deduction ($6,000 for joint returns). Personal exemption increased to $1,500. Effective date: 1/1/86	4 rate brackets: 15%, 25%, 35%, and 30%. The personal exemption would be $2,000 ($1,500 for itemizers). The standard deduction would be $4,800 for joint returns. Effective date-7/1/86.
B. Individual Minimum Tax	Individuals with large amounts of tax preference must pay a minimum tax of 20% if this exceeds regular tax liability. There is a $40,000 exemption for joint returns.	Generally the same as present law, but exemptions are lowered ($15,000 for joint returns) and preference base is modified.	Rate increased to 25% and present law exemptions retained. Base broadened to include limited partnership losses and interest from IDBs as preference items. Effective date: Tax years beginning after 12/31/85.	Same as staff option.
C. Corporate Minimum tax	Corporations are subject to add-on minimum tax at 15% rate. Exemption is $10,000 or regular tax liability.	Converts add-on minimum tax to alternative minimum tax (similar to individual minimum tax). 20% rate. $25,000 exemption.	25%-rate alternative minimum tax. $40,000 exemption. Interest from IDBs would be a preference item. Effective date: Tax years beginning after 12/31/85.	Same as staff option.
D. Corporate tax rates	The top corporate tax rate is 46%.	Top rate reduced to 33%.	Top rate reduced to 35%. Effective date: Tax years beginning on or after 1/1/86.	Top rate reduced to 36%. Effective date-Taxable years beginning after 7/1/86.
E. Contributions in aid of con-construction	Contributions in aid of construction to a public utility are treated as nontaxable contributions to capital.	No provision.	Treats contributions in aid of construction as taxable income. Effective date: 1/1/86	Same as staff option.

The CHAIRMAN. Thank you very much. I appreciate your testimony.

Last we have Mario Borini of Seidman & Seidman.

Mr. Borini.

STATEMENT OF MARIO P. BORINI, PARTNER, SEIDMAN & SEIDMAN, NEW YORK, NY

Mr. BORINI. Thank you, Mr. Chairman.

I'm here on behalf of the international accounting firm of Seidman & Seidman. Our firm advises numerous small and midsized businesses with respect to their business and tax affairs and has done so for over 75 years.

We know the issues, both tax and economic, that are of pressing concern to America's small business. These concerns of small business include the ability to raise and conserve capital, the ability to hire and retain employees, the ability to comply with Federal and other recordkeeping requirements, and, perhaps most important of all, the ability to compete effectively with their larger, older brethren. The Tax Code and the incentives that it provides for small businesses can either make or break many American entrepreneurial ventures.

I will now briefly discuss those tax proposals which we feel are of the greatest significance to small business. I have submitted a more complete statement and an outline of that statement for the record.

Many tax proposals that are contained in the House bill would drastically reduce funds available to small business. Our present tax system helps to generate funds required by small business through savings stemming from liberal depreciation deductions and tax credits.

Turning to the House depreciation proposals, under the proposed incentive depreciation system, IDS, the types of property most often used in small business would generally be subject to substantially longer depreciation periods, covering from 5 to 10 years. Obviously, the less capital investment a small business can write off in the early years of the investment, the less funds it will have for expansion. We feel, instead, that the accelerated cost recovery system, ACRS, has worked well since it was introduced in 1981 and should not be tampered with any further.

Turning to the investment tax credit, the proposed elimination of the investment credit would substantially impair the ability of capital-intensive small businesses to invest in new property, plant, and equipment. If it is too costly to provide an across-the-board investment credit, at a minimum it could be provided for limited amounts of capital investments, say up to $100,000 a year, or some other amount that makes sense in maintaining the revenue neutrality of any tax bill.

Turning to employee stock option plans, ESOP's, let me point out that it is the most effective capitalist invention designed to provide workers with an opportunity to own their own employer companies, to own the means of production. We believe that the amendments to the current ESOP rules in the House bill threaten the very existence of this viable economic device. It is extremely difficult for small businesses to obtain financing for this purpose. Leveraged ESOP's provide commercial lenders with one of the few attractive small business financing alternatives. Since under present law a lender must only include 50 percent of its earnings on ESOP loans in income, it is willing to take the risk of small business financing under these circumstances. Repeal of this preferential treatment as proposed by the House will eliminate the most viable source of funds devoted to workers obtaining a stake in business America.

Other House proposals that curtail ESOP's are discussed in my written statement, all designed to curtail the viability of ESOP's, which we believe is detrimental to everything that America stands for—the right of a worker to have an equity investment in the business to which he devotes his life.

Many of the tax proposals currently under consideration would significantly increase the recordkeeping burden imposed on small business. Implementation of a new depreciation scheme such as the IDS, which I mentioned earlier, would result in many businesses, both small and large, having to keep records under at least four Federal tax depreciation systems for property acquired during the 1980's, a ridiculous state of affairs.

If we look more closely at IDS, it is clear that this system takes a giant step away from the truly easy-to-apply tenets of ACRS. After the recordkeeping complexity, IDS deductions will be subject to inflation adjustments beginning in 1988. Calculation of the inflation adjustment is very complex. In our experience few small businesses are equipped to comply with the recordkeeping mandated by such depreciation rules. The burden becomes intolerable when all previous deduction systems which may be applicable are factored in.

Accounting for inventories, as you have heard this morning, Mr. Chairman, is extremely burdensome to small businesses. Any method of accounting of inventory is complex and costly to maintain. The House proposal to allegedly simplify LIFO is no exception. Put aside small business for a moment; consider that very few accountants in this country can accurately compute LIFO inventories. A better approach would be to eliminate entirely the inventory accounting requirement for small business. This would ease the recordkeeping burden and facilitate administration of the tax law and permit small businesses, as has been advocated here this morning, to adopt a cash method of accounting, which is a simple way for accounting for income, and, frankly, one that the IRS imposes on all individuals.

There is a need for special tax rates for small business. Graduated tax rates allow the small business in its early years of profitability to keep more of its earnings and plow them back into building the business. We do not feel that the graduated rates proposed in the House bill provide sufficient business assistance. We emphasize the need for a greater degree of graduation in the rates.

Turning to the dividends paid deduction, the House bill includes a phasein over 10 years of a deduction for up to 10 percent of certain dividends paid by a domestic corporation. This proposal is of no value to the vast majority of small business. Most can barely pay their owner employees adequate salaries. There are certainly no funds left to worry about whether or not dividends should be paid. Furthermore, the provision is extraordinarily complex and would require recordkeeping well beyond the capabilities of most small businesses.

If there is a need for additional revenues in the search for neutrality, this is one of the proposals that your committee could suggest eliminating in exchange for other small business tax incentives we suggest. Shortness of time prevents me from discussing in greater detail these and other tax proposals harmful to small business. I urge you to read my statement and summary which develops these concerns and suggests remedies.

Thank you.

[The prepared statement of Mr. Borini follows:]

Seidman
&
Seidman | BDO
15 Columbus Circle, New York, New York 10023 (212) 765-7500, TLX 661 903

STATEMENT

of

Mario P. Borini, CPA, PhD.
National Director of Taxation
Seidman & Seidman/BDO

Submitted for the Record of

SENATE SMALL BUSINESS COMMITTEE HEARINGS

Held February 6, 1986

I thank you for letting me present the views of our Firm on the current tax reform proposals that we feel will have the greatest impact on small business. For over 75 years, Seidman & Seidman/BDO has provided tax services to America's emerging and mid-sized businesses. We believe, therefore, that we are well-versed in the tax problems encountered by the entrepreneur.

Many Tax Proposals Would Drastically Reduce Funds Available to Small Businesses

Borrowed capital, if available at all to small businesses, comes at an inordinately high cost. The Small Business Administration (SBA) has reported that small companies are particularly sensitive to a "credit crunch" during a recession, and prey to the uncertainty of floating interest rates. Bank interest rates are steep for these ventures; sometimes as much as five, six or seven percentage points higher than for large public corporations.

Changes in the commercial banking industry are adversely affecting the ability of small businesses to obtain loans. Many small businesses have relied on small, locally-controlled banks as their prime source of debt financing. However, we may be witnessing a disappearance of such small, local banks. As a result, small businesses may turn to other lender-investors, such as pension funds and insurance companies. But these sources as well as individual investors are unlikely suppliers of capital to small businesses. Elimination of the SBA has also been proposed. Without SBA financing, the borrowing power of small businesses may be further strained. Just as small business funding sources are becoming scarce, current tax proposals would decrease even more the funds available to small business.

Depreciation Proposals

The proposed Incentive Depreciation System would stretch out the depreciable lives of property from the current 3 to 19 year periods provided under the Accelerated Cost Recovery System (ACRS) to periods ranging from 3 to 30 years. The types of property most often used in small business would generally be subject to substantially longer depreciation periods. For example, the depreciable life of a pickup truck would be extended from 3 to 5 years while the life of office furniture, fixtures and equipment would be stretched from 5 to 10 years. Obviously, the less capital investment a small business can write off in the early years of the investment, the less funds it will have for expansion.

The Accelerated Cost Recovery System (ACRS), for the most part, establishes periods over which it is relatively reasonable to write off capital costs. Extending these periods simply makes it more costly for capital-intensive small businesses to expand. ACRS has worked well since it was introduced in 1981 and should not be tampered with any further.

Tax Credits

The proposed elimination of the investment credit would substantially impair the ability of capital-intensive small businesses to invest in new property, plant and equipment. Under current law any business can recover up to 10 percent of such expenditures through the investment credit. Small businesses are particularly dependent on the funds obtained through the investment credit to make capital investments affordable. Competing with foreign imports from low labor-cost countries is already difficult enough without increasing U.S. capital costs even more through elimination of the tax incentives. If it is too costly to provide an across-the-board investment credit, at least a limited credit should be provided to assist small businesses in entering the competitive fray. All U.S. industry appears to need this incentive but it should, at a minimum, be provided for certain amounts of capital investment--perhaps for investments of up to $100,000 per year or some other amount that makes sense in maintaining the revenue neutrality of any tax bill.

Small service businesses, too, have trouble funding their initial ventures. They benefit very little from the tax incentive provided by the investment credit, but they could be greatly assisted by a new jobs tax credit similar to that made available to businesses in 1977 and 1978. Such a credit would also further the U.S. economic goal of putting more people to work. If it is considered too expensive to provide this credit for all new jobs provided, this credit as well could be capped at some reasonable amount that would still serve to make small businesses more competitive.

ESOP Funding Incentives

The House Bill would repeal the exclusion for 50 percent of the interest earned on certain securities acquisition loans made in connection with Employee Stock Ownership Plans (ESOPs). In so doing, it would virtually eliminate the ability of small businesses to finance expansion through the use of ESOPs. Currently, through the use of a leveraged ESOP, an employer can provide benefits for employees while obtaining a deduction for loan principal payments (within certain limits), as well as loan interest.

Typically the leveraged ESOP borrows money from a commercial lender in order to purchase the employer's shares. The loan is usually secured by the stock and guaranteed by the employer corporation. Then the leveraged ESOP uses the loan proceeds to pay the employer for the shares of stock it has contracted to purchase. The employer will make annual cash contributions to the leveraged ESOP in an amount sufficient to meet scheduled loan principal and interest payments. As a result, the employer receives the loan proceeds for use in the business and in future years will make tax-deductible contributions to the leveraged ESOP sufficient for the ESOP to make loan repayments.

It is already extremely difficult for small businesses to obtain financing. Leveraged ESOPs provide commercial lenders with one of the few attractive small business financing alternatives. Since the lender must only include 50 percent of its earnings on ESOP loans in income, it remains willing to take the risk of small business financing under these circumstances. Elimination of this preferential treatment will eliminate one of the few remaining sources of small business funding.

Net Operating Loss (NOL)

Under current law a taxpayer may carryback an NOL three years and over fifteen years until it is used to offset taxable income. If insufficient taxable income is generated the carryforwards will expire. If a corporation with NOL carryforwards (loss corporation) is acquired, the NOLs are generally preserved as long as the loss corporation continues in the same trade or business. The House Bill would limit the application of net operating loss carryovers when a more than 50 percent change of ownership occurs. This provision was intended to discourage tax-motivated acquisitions.

In our opinion the proposal to limit the application of NOL carryforwards will have an adverse impact on start-up and emerging small businesses. The first years of business are always the toughest. The business must find its niche, become established, and deal with countless growing pains. Many promising businesses survive only because they are able to obtain new investment to sustain them during the hard times. It is no secret that the availability of tax benefits is often a crucial factor in attracting this new investment. We feel that the ability to transfer tax benefits is a positive aspect of the current tax system and should be retained.

Restrictions on the ability to transfer net operating losses through the sale of a business may discourage the entrepreneur from making a major financial investment in the small business. Where it is possible to sell a loss company to a buyer who is willing to continue the business provided he can benefit from its tax loss carryforwards, the entrepreneur is encouraged to invest additional funds knowing that he will at least be able to recoup a portion of these funds through sale of the tax benefits if the business fails.

Need to Attract and Retain Key Employees

Tax-Free Liquidations

Under current law, a corporation generally does not recognize gain on liquidating distributions of appreciated property. For example, no gain would be recognized by a liquidating corporation if land with a $500,000 value and $100,000 basis is distributed to shareholders in exchange for their stock. The shareholders receiving the land would recognize gain to the extent its $500,000 value exceeds their stock basis. Similarly, under Section 337 of the Internal Revenue Code, a liquidating corporation would not recognize gain on property sold where the proceeds are distributed to shareholders in exchange for their stock. These principles are a matter of long-standing public policy. The objective is to put shareholders in the same after-tax financial position whether: they sell their shares directly; the corporation sells its assets and then liquidates; or the corporation distributes its assets to its shareholders in liquidation and the shareholders sell them. Note that these provisions primarily impact small corporations--larger corporations usually take on a life of their own; they rarely liquidate.

The House Bill generally overturns this long-standing policy. Virtually all distributions or sales of appreciated property, even by liquidating corporations, would be subject to tax. An exception is provided for an "active business corporation" to the extent of its "qualified stock". Under the exception, a liquidating corporation would not recognize gain attributable to the portion by value of the liquidating corporation's stock that is qualified stock on the date the plan of liquidation is adopted. "Qualified stock" is stock that has been held by a noncorporate shareholder for at least a five-year period during which such shareholder held at least 10 percent in value of the outstanding stock of the liquidating corporation. The bill also extends this rule to Sec. 337, providing for nonrecognition of gain or loss to a liquidating corporation on a sale of assets to the same extent nonrecognition would have been available on a liquidating distribution.

As a practical matter, the "qualified stock" exception preserves Sec. 337 for many small businesses because ownership usually rests with a few, often related, shareholders. Consequently, in many cases the stockholdings will constitute qualified stock. However, problems arise in those situations where key personnel have received stock as an incentive to stay with the company or use their best efforts to help it grow. In that case, ownership by the key employees will often be less than the 10 percent needed to constitute qualified stock.

By previously sanctioning Employee Stock Ownership Plans (ESOPs) and Incentive Stock Options (ISOs), Congress has approved the use of stock incentives to motivate employees. The contemplated changes in Sec. 337 would have the opposite effect. They would discourage the issuance of minority shares to employees because the corporation, and ultimately the shareholders, would be penalized by higher taxes if the corporation liquidates.

The primary reason for changing the tax law in this area was to discourage the recent flood of corporate takeovers. This was done by making Sec. 337 no longer apply when Sec. 338, which treats a stock acquisition as an asset acquisition, is elected.

In our opinion, the objectives of the House Bill can be realized by making Sec. 337 inapplicable when a Sec. 338 election is made, but without otherwise changing Sec. 337. For that reason, and to continue to encourage employee participation in stock ownership, we recommend that Sec. 337 itself not be changed.

ESOPs

Numerous changes have been proposed with respect to the tax treatment of Employee Stock Ownership Plans (ESOPs). Many of these proposals would decrease the attractiveness of ESOPs to the point where these plans would no longer be viable as a tool to encourage employee ownership. The House proposals in this area are more palatable than those of the President, but they too would emasculate the effectiveness of ESOPs.

The requirement that ESOP participants with ten or more years of service have the right to direct the ESOP trustee to vote allocated securities with respect to any corporate matter, whether or not that matter must be decided by more than a majority vote under either the law or the corporate charter, leaves companies that establish ESOPs in the unpleasant position of possibly having minority shareholders second-guess every corporate decision. Most corporations will simply decline to set up ESOPs or refuse to make any additional contributions to existing ESOPs rather than submit to this peril.

The House Bill also contains a requirement that the valuation of employer securities contributed to or purchased by an ESOP be determined by an independent appraiser. An independent appraisal is an expensive product and should not be required in all situations. ESOPs are often considered as an alternative to selling a small business to an independent third party. Where there is a verifiable arms-length offer from a willing buyer, an independent appraisal is a needless expense.

A major incentive to many small business owners for setting up an ESOP is the ability to phase out of the business on a tax-deferred basis by investing the sale proceeds in qualified securities and, thereby, not recognizing any gain currently on the sale to the ESOP. By abolishing this tax deferred rollover of gain, the House Bill once again encourages an older small business owner to retain control of his business until death when the business can pass through his estate and obtain a stepped-up tax basis. In that event, there is frequently no planning for the continuity of the business and the protection of its employees as there is where ownership is gradually transferred to those employees.

Cash or Deferred Arrangements [IRC Sec. 401(k)]

Cash or deferred arrangements (CODAs), although part of the Internal Revenue Code for years, have only recently gained popularity. Under a CODA an employee may elect to defer the receipt of cash compensation and have the deferred amount contributed as an "elective contribution" to a qualified profit-sharing or stock bonus plan. If the CODA meets certain qualification requirements, the employee is not currently taxed on his or her elective contributions. Specific tests apply to ensure that highly compensated employees do not defer significantly higher percentages of compensation than rank-and-file employees.

The President's proposals and the House Bill would sharply curtail the benefits of CODAs. The maximum contribution allowed would be limited to $7,000 ($8,000 under the President's proposal). Under the House Bill, allowable IRA contributions would be reduced dollar-for-dollar by contributions to a CODA. Thus if an employee elects to have $2,000 of salary contributed to a CODA, no IRA contributions can be made. The President's proposal works in the opposite direction, reducing the CODA limit by the employee's IRA contribution.

Here are some reasons offered for limiting CODA benefits:

- CODAs encourage employers to shift too large a portion of the share of the cost of retirement savings to employees.
- CODAs should be supplementary retirement savings arrangements for employees, not primary retirement plans.
- These plans permit significant contributions by highly compensated employees without comparable participation by rank-and-file employees.
- CODAs inequitably provide covered employees with a greater opportunity to defer compensation than employees who must rely on IRAs.

The first two reasons suggest that the duty to provide retirement benefits rests primarily with employers. Shades of Marie Antoinette--if employers cannot afford to sponsor retirement plans, let the employees eat cake! Diatribes proclaiming the responsibilities of employers are appealing, but they don't face up to the reality of the workplace.

The fact is that many small businesses cannot afford to adopt traditional retirement plans. By adopting CODAs employers give their employees the opportunity to set aside meaningful savings for their retirement, rather than the token amount allowed by IRAs. The employer's alternatives may well be to offer a CODA, or offer no retirement plan at all. Making CODAs less attractive will only discourage employers from adopting them.

In our opinion the percentage tests which restrict the amount of deferral allowed highly compensated employees are sufficient. Our experience shows that these plans are embraced wholeheartedly by rank-and-file employees and that the percentage of compensation tests are easily satisfied. However, if there must be a trade-off between adopting tougher percentage of compensation tests and lowering contribution limits, we favor the former.

If there must be an offset between IRAs and CODAs limiting the total annual contribution under both plans, we prefer the President's approach of reducing CODA limits by IRA contributions rather than the measure passed in the House Bill.

CODAs have become popular over the last few years because many small businesses that could not afford conventional retirement plans were able to hire qualified workers by providing them with an opportunity to save some of their earnings for retirement on a tax-favored basis. By any measure this is a positive development. Companies can provide benefits that they otherwise could not afford. Employees can save for retirement in a convenient, systematic manner. With all of the fear that the Social Security System will fail, and the complaining about the low U.S. savings rate, it makes little sense to cut back on a program that can help alleviate these concerns.

Tax Proposals Which Would Compound Recordkeeping Complexity

Incentive Depreciation System

Many of the tax proposals currently under consideration would significantly increase the recordkeeping burden imposed on small business. Implementation of a new depreciation scheme such as the Incentive Depreciation System (IDS) would result in many businesses, both small and large, having to keep records under at least four Federal tax depreciation systems for property acquired during the 1980's. The following depreciation methods have already been used for tax purposes at various points since 1980: traditional depreciation methods (including straight-line, sum-of-the-years' digits, etc.), the Asset Depreciation Range System (ADR), and the Accelerated Cost Recovery System (ACRS).

Keeping records for four Federal sets of depreciation methods would be bad enough. However, the various states may require that methods other than those used for Federal purposes be employed in computing state taxable income. This requirement could add up to another four methods of calculating depreciation. But that's not all. Many companies use an entirely different method of calculating depreciation for financial statement purposes. As a result, utilization of as many as twelve methods could be required for computing depreciation in any one year if yet another depreciation scheme is added! This, in and of itself, is certainly not simplification.

However, if we look more closely at IDS, it is clear that this system takes a giant leap away from the truly easy-to-apply tenets of ACRS. IDS first requires determination of the ADR midpoint life of an asset. IRS Revenue Procedure 83-35 contains well over 100 classifications that must be considered when finding the midpoint life of each asset. Once the midpoint life of an asset is determined, the taxpayer must then correlate this with the ten IDS groupings to determine its depreciation category. Such an exercise, when required for each asset purchased during the year, adds an enormous administrative burden to the small business which purchases during the tax year numerous capital assets which fall into various IDS categories.

To add to the recordkeeping complexity, IDS deductions will be subject to an increse for inflation adjustments beginning in 1988. To compute this adjustment, the IDS deduction would be multiplied by the product of the allowable inflation adjustment for the taxable year plus that for each prior taxable year during the taxpayer's holding period of the property. However, an inflation adjustment is computed for a taxable year only if inflation for the calendar year in which the taxable year begins exceeds 5 percent. In that event, the inflation adjustment will be the sum of one plus one-half of the inflation rate in excess of 5 percent. For this purpose, the House Bill provides that inflation in a calendar year is the percentage increase in the CPI over the one-year period ending with August 31 of that calendar year. In our experience, very few small businesses are equipped to comply with the recordkeeping mandated by such depreciation rules. The burden becomes intolerable when all previous depreciation systems which may be applicable are factored in.

Accounting For Inventories

Inventories are required to be maintained and accounted for in all cases where the production of merchandise for sale is an income-producing activity. The last-in first-out (LIFO) method of inventory accounting has gained popularity because it reduces income during inflationary periods by more accurately matching the cost of items sold to sales revenue. The House proposes a new "simplified" LIFO method because the complexity and greater costs of compliance associated with the existing LIFO method tax rules have discouraged small businesses from adopting it. However, only taxpayers with average annual gross receipts of $5 million or less over the three preceding taxable years would be eligible to adopt the new simplified LIFO method.

Any method of accounting for inventory is complex and costly to maintain. The House proposal is no exception! A better approach would be to eliminate entirely the inventory accounting requirement for small businesses.

Most small businesses are not equipped with recordkeeping systems sophisticated enough to keep accurate inventory tallies. Alternatively, few have the resouces to take annual physical inventories. And almost none have mastered advantageous methods, such as LIFO, which would enable them to save taxes. In fact, very few accountants can accurately compute LIFO inventories.

Elimination of the need for inventories for small businesses would greatly simplify their recordkeeping burden and would probably cost the Treasury very little in the long-run. Most small businesses don't have the financial resources to substantially inflate their purchases and, thereby, distort their taxable income. To further eliminate this potential problem, a provision could be included to disallow deductions for purchases which appear to have a tax avoidance motive.

Furthermore, under current law the accrual method of accounting must be used whenever inventories are maintained. Elimination of inventory accounting requirements would permit more small businesses to use the cash method of accounting.

Cash Method of Accounting

Both the President's proposals and the House Bill place several restrictions on the use of the cash method of accounting for tax reporting purposes.

The cash method of accounting recognizes items of income and expense based on the taxable year in which funds are received or disbursed. Opponents of the cash method charge that it: fails to accurately reflect the economic results of a taxpayer's trade or business over a taxable year; is not in accord with generally accepted accounting principles; and, produces a mismatching of income and deductions when all parties to a transaction use different methods of accounting. Under the proposal some small businesses, those with average annual gross receipts of $5 million or less, may continue to use the cash method because it is a simpler method, thereby avoiding the higher costs of compliance which would result from switching to the accrual method.

While recognizing that the cash method of accounting is not in accordance with generally accepted accounting principles (GAAP), we do not endorse the view that the cash method results in material distortions of taxable income. One of the foundations of our tax system is that tax should be imposed at that point in time when funds are available to pay it. A clear example is that prepaid rent is taxable in the year received even though not yet earned. Indeed, very little in the Tax Code complies with GAAP. Not surprisingly, the distortions that arise almost uniformly err in favor of the Government.

Our objection to both the President's proposal and the House Bill is that many small taxpayers would be precluded from using cash method accounting. We believe that the artificial $5 million threshold is too low. Extending the cash method to more taxpayers would be worthwhile for both taxpayers and the government. The simplicity of the cash method of accounting encourages better compliance with the tax system, thereby easing administration. Further, any revenue shortfall would be temporary because income deferred by using the cash method would likely be recouped within a year.

Need For Special Tax Rates

Graduated Tax Rates

Graduated tax rates allow the small business, in its early years of profitability, to keep more of its earnings and plow them back into building the business. Under the House Bill, the first $50,000 in corporate taxable income would be taxed at a maximum rate of 15 percent, while the next $25,000 in taxable income would be taxed at 25 percent and the next $25,000 at 36 percent. However, once the corporation's taxable income tops $100,000, the benefits of the lower tax rates are phased out through the imposition of a 5 percent surtax. Once the corporation's taxable income exceeds $365,000, it will be subject to tax at a flat 36 percent rate. This concept of making graduated corporate rates available only to the small business is a good one, but $100,000 is too low a threshold for starting to phase out graduated corporate rates. Under current law, the benefit of graduated rates is not diminished until a corporation's taxable income exceeds $1,000,000.

Dividends Paid Deduction

The House Bill includes a phase-in over ten years of a deduction for up to 10 percent of certain dividends paid by a domestic corporation. This proposal is of no value to the vast majority of small businesses. Most can barely pay their owner/employees adequate salaries. There are certainly no funds left to worry about whether or not dividends should be paid. Furthermore, the provision is extraordinarily complex and would require recordkeeping well beyond the capabilities of most small businesses.

If there is a need for additional revenues in the search for revenue neutrality, this is one of the proposals that your Committee could suggest eliminating in exchange for other small business tax incentives we suggest.

I thank you for the opportunity to appear before you. I would be happy to answer any questions you have and to work with you in making the tax climate more favorable for small business.

The **Chairman**. Thank you all very much. Your statements in their entirety will be read by the chairman certainly and staff and the committee.

I think it has become very clear from these hearings that, unless there is a substantial overhaul by the Senate, it's going to be very inimical to the interest of small business insofar as the proposed legislation coming out of the House. Whether or not there is time to go ahead and make that kind of a draft, I suppose Chairman Packwood is better able to answer that question. But you certainly have given to the committee very valuable views when the time comes to review the work of the Senate Finance Committee. I thank you all.

The committee will stand in recess.

[Whereupon, at 11:21 a.m., the committee recessed to reconvene at the call of the Chair.]

THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

MONDAY, FEBRUARY 10, 1986

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Oklahoma, City, OK.

The committee met, pursuant to notice, at 3 p.m., in Court Room One, Federal Court House, Oklahoma City, OK, Hon. Don Nickles (acting chairman of the committee) presiding.

Present: Senator Nickles.

Staff Present: William H. Langdon, professional staff member; and Bret Bernhardt, office of Senator Nickles.

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA, AND ACTING CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator NICKLES. We will go ahead and begin.

I want to thank those who have joined us. Some had to come from difficult circumstances due to the weather, from out of Oklahoma County and have joined us, and I'm appreciative of your efforts in coming. Today we will have a hearing before the Small Business Committee to consider the impact of the various tax proposals, both the House-passed tax bill and also the President's tax bill, commonly called Treasury 2.

I'm primarily interested to learn from individuals on how either or both of those bills would impact industry and small business in the State of Oklahoma. I think it's important as we consider very complicated legislative matters such as this, and that the House-passed tax bill, several hundred pages, I think it's important that we receive input from Oklahoma on how the various proposals would affect them, their business and their employees.

I think we've got some outstanding witnesses today, but just a couple of general comments:

I'm very pleased that the Senate is not going to begin markup of either the House-passed bill or Treasury 2. I find both tax bills leave a lot to be desired, both need substantial improvement, and I think the best way to initiate an effort if we're going to have so-called tax reform would be to start from afresh and not with either of the two pending proposals. Both of them leave a lot to be desired in this Senator's opinion, particularly from an Oklahoma perspective.

I've also mentioned that I have cosigned with several other Senators a letter to the President stating my belief that deficit reduction is our primary responsibility this year, and that we should, before taking on the difficult and complicated and controversial task of tax reform, first initiate and complete a deficit reduction package.

I think that's the focus, and I believe that's the majority of the sentiment in the Senate, and I hope that that will be the case.

Again, I'm not here to make speeches on my opinion of the tax reform measure. I am here to hear from Oklahomans, hear their view on how they believe this tax proposal would affect them and their companies and their employees.

[The prepared statement of Senator Nickles follows:]

Statement of Senator Don Nickles
The Impact of Tax Reform on Small Business
February 10, 1986

The issue of tax reform has caught the attention of business across the nation. Today's hearing of the U.S. Senate Small Business Committee will determine what impact such reform could have on various Oklahoma businesses.

There are two proposals that have received the most attention. The first was proposed by the Administration last May. The second passed the U.S. House of Representatives in December. We will focus on these two proposals at this hearing.

Both plans call for a massive rewrite of the tax code and a shifting of taxation away from individuals to businesses. Included are changes in capital cost recovery and rate structure, the taxation of pensions, fringe benefits, natural resources, financial institutions, and others.

In Oklahoma, the creation of jobs is a vital goal of economic development. This needs to be taken into consideration when dealing with tax reform. For example, as we will hear today, the House plan would reduce drilling expenditures by more than 10 percent. This translates into fewer oil and gas drilling rigs in operation which employs approximately 273 persons per rig. We cannot suffer that kind of setback in our state's economy.

This hearing will assist both the Senate Small Business Committee and the Senate Finance Committee in their review and drafting of tax reform legislation. I welcome our witnesses and look forward to hearing their remarks.

Senator NICKLES. We have several outstanding witnesses. First today, we have Bill Rodgers, who is chairman of the board of Security Bank & Trust Co. from Blackwell, representing the Oklahoma Bankers Association; we have Scott Jenkins, vice president for external affairs with Weyerhaeuser Co.; and Tom Stephens, who is vice president and treasurer of Kerr-McGee Corp. of Oklahoma City.

So our panelists—Bill, do you care to be first?

STATEMENT OF WILLIAM W. RODGERS, CHAIRMAN OF THE BOARD, SECURITY BANK & TRUST CO., BLACKWELL, OK; REPRESENTING THE OKLAHOMA BANKERS ASSOCIATION

Mr. RODGERS. Thank you, Senator Nickles. It is an honor to be here and represent my industry in Oklahoma.

First let me state that I have prepared a brief résumé—an outline of my remarks today, and I think I'll follow the outline that's on page 1——

Senator NICKLES. OK.

Mr. RODGERS [continuing]. If that would be helpful to you.

First of all, I would like to emphasize how much we support the President's tax reform concept, that we feel like that the present Tax Code is out of date and even promotes cheating among some of our taxpayers, and is so complicated and difficult to understand that small business has a tremendous burden in trying to understand many of its provisions.

As you might understand, Blackwell, OK is small business. Most of our business in Blackwell has been small business, and its success is our success. We have been unable to attract large corporations to our community. Therefore, we are very concerned about the future of small business and its profitability.

I would like to point out and emphasize to you that we agree with you 100 percent on deficit reduction. We feel like that if we're going to be successful with small business, we have to have stability. And in the last few years, as you know, it has been very difficult to forecast the future when we have had interest rates to change as rapidly as we've had. We've had an economy expanding and contracting practically every year, and we sit down with our customers, we make a plan for the future. It's very difficult when long-range planning is 6 months, and we don't know from one point to another what interest rates are going to be, whether he can attract capital, whether the economy is going to be strong or poor, and just what condition we're going to be in. We don't know how the regulatory authorities are going to look at banks. We don't know whether they're going to want us to be out there making more loans or are they going to feel like loans are not good at this time and they're going to be very strict on us.

While generally we propose—we favor the President's tax reform and generally we would favor most of the items in it, there are some items, and particularly two that affect banking adversely, and because of that, we would be against H.R. 3838. Basically those are in two general areas: One is the repeal of the bad debt reserve deduction, and the other one is the denial of the bank's ability to deduct interest paid to carry tax-exempt bonds. I would also like to briefly state my opinion in one other area which is a personal opinion relating to the Small Business Administration.

Let me start, if I may, with the repeal of the bad debt reserve deduction. For 49 years, banks have been able to set aside a reserve which anticipates their bad debts in their loan portfolio. What it does simply is this: It does not make you go through your loan portfolio and say, "This loan is bad, we're going to charge it off, and this loan is bad." We know out of experience a certain amount of loans in our portfolio will not pay as agreed. We also know as the economy contracts or has problems, we know that more of those loans are bad than in good times. But we sometimes do not specify which loans are bad and which loans aren't. We feel like it's good protection for the bank to have an adequate reserve set aside for bad debts. If you're a banker in Oklahoma today, you know that in spades. You know that, more than ever, you've got to have a good reserve to set aside on loans that may go bad, because probably most of your loans today are going to be in the real estate business, the energy business or in ag business, and you've seen those kind of markets and what they've done in our economy in the last couple of years. So, we feel more than ever we need to have an adequate reserve.

And this is along the lines of the thinking of the Comptroller of the Currency, the FDIC, and the Security and Exchange Commission. They want reserves set aside by banks so in case to handle bad debts that might occur in their portfolio.

What the change does, what the bottom line really is in this whole affair is, the Treasury's afraid that the banks are taking abuse of their loan loss reserve. In other words, they feel like that the loan loss reserve is distorted, I mean it's expanded to the place that it doesn't represent our bad debts in the bank. What I'm going to try to say here in a few minutes is, that simply is not true.

Banks in Oklahoma today certainly have, and could say in most cases have more chargeoffs than set in their loan loss reserve provisions, and what we're looking at now is, is the new law under H.R. 3838 says that you have to specifically charge off a loan before you get a tax deduction for it.

In Blackwell, OK, we have a lot of ag customers, and because of the decline in farmland, the decline in just general assets in farming, we know that in our ag loans, there are loans that probably are going to be charged off over the next few years. We hesitate to have to go in early and charge those loans off. Bank examiners once you charge a loan off, you will limit yourself what you can do with it. In other words, you better go out and collect it. We don't want to have to do that. We feel like—we know that there are some bad loans there because of the depressed conditions of agriculture, but we feel like it's a great burden on banks to make them charge specific loans off when yet the don't know for sure if that loan is going to be a chargeoff. We know that land values in Kay County have been depressed about 40 percent in agriculture. But yet we don't know which loans that—how much that's going to affect each individual loan. Some farmers will make it and some will not. But it makes us, in order to get a tax deduction, to go in early and make a chargeoff. If we didn't do that and said we're going to hang on and hang on, then we might find ourselves one year with a tremendous amount of chargeoffs and we are not prepared to take those. So, we feel like that the reserve for bad debts in logical form is an excellent backup for banks and is safeness and soundness.

One other thing I would like to point out with regard to the reserve for bad debts is that there is a Senate bill, S. 1263, that is sponsored by Senator Roth and Senator Boren, that says—that modifies the approach taken and says, "OK, you can have reserve for bad debts and you can have it to the extent that you use it on your financial statement or are forced to do it for other regulatory authorities." In other words, it admits that there needs to be a reserve for bad debts, and not a reserve that's taken only when you charge a loan off, and that when you have to have a financial statement for the FDIC, for example, it should be the same as what you file for your tax return.

Right now, we are limited to six-tenths of 1 percent of our total loans under the percentage method for reserve for bad debts. We're given two alternatives: One is six-tenths of 1 percent, which is not an enormous figure, or you can have an experience method, if you take all your chargeoffs over the last 6 years and average them. At the end of 1987, you have to go on the experience method. So, we are saying to you is that we feel like the reserve for bad debts is a proper thing for banks to have, and the reserves that have been set up now are ones that we continue on with, and if we are forced to charge off loans to get deductions, then that's going to make a burden on our customers and a burden on banks. And we really don't feel that we're hiding income in our reserve for bad debts, and that's the bottom line as to what they're afraid of.

Moving on to the second item which I'd like to approach in a positive vein rather than a negative, what they're really doing is keeping banks from buying tax-free or tax-exempt bonds. They're saying, that's—for years they have been more or less jealous of banks who paid very little tax, and they say, you know, "You owe your fair share and you're going to pay it." Well, historically banks who have bought—who have not had high loan-to-asset ratios have bought municipal bonds. And you can argue that they pay a tax by doing that. Effectively what we have done is lower the price of doing business to the municipalities or government agencies by which we buy municipal bonds. If we remove the ability of banks to but tax-exempt bonds, then what do we do with those agencies who issue them? The banks are the second biggest buyers of tax-exempt issues in the United States. And if I just think back to Blackwell, OK, a little bit, the last 20 issues of municipal bonds have been bought by banks. I don't know where they're going to get their financing. But say they do; it is still going to be a higher cost to the local municipality or to the government as to be able to fund those projects.

Relating that to small business just for a second, that's going to be more cost the city's going to have to pass on to its taxpayers to cover the increased costs they're going to have to issue bonds. What they're afraid of is that banks are hiding their revenues in tax-exempt bonds, that we're not paying our fair share. You know, banks want to pay their fair share. I mean, I don't thing anybody in the banking industry who is making money says, "Gosh, I don't want to pay it, but by the same token, we want to buy municipal bonds." We feel like it is helpful to our communities and the people around us for us to be in that market. If they effectively eliminate us, then that's just going to be an added price tag that somebody's going to have to absorb somewhere.

There's one other thing I would like to point out in that area, that in H.R. 3838, it says simply that the effect upon banks, you must sell—these tax-exempt securities are only effective for ones you purchase after January 1, 1986. For example, if the bank in Blackwell would have securities that we've had before then, if we want to sell them after that date, we can't sell them to banks. And it puts an undue burden on us to try to sell our municipal bonds when you eliminate banks from buying them.

So, what we're asking is this: That there be an amendment to H.R. 3838. And if you decide to go along with it that just says the effect of this bill will occur at the passage of the tax bill and not retroactive back to January 1, of 1986.

If I need to sell my municipal bonds, I need to have the liquidity to be able to do that, and if I eliminate those bonds to being purchased by other banks, then I've really hurt myself in not being able to find a buyer for those bonds.

We feel like we can benefit communities by continuing to be there on the market, and we hope that you will see it fit to keep that item in where the banks can buy municipal bonds and tax-exempt bonds.

Last is a personal experience. I know the bill provides for elimination of the SBA, the Small Business Administration. And we're here to talk about small business. In 1972, Blackwell lost its major employer, Blackwell Zinc Co., of which I think, as you know, 825 employees were lost out of our community, out of a town of 8,000. We were pronounced dead. In fact, there was an article in the Wall Street Journal that said "Black Day in Blackwell" right on the front page, and it said that—they predicted the demise of the small community.

In 1976, they retracted that statement with a lead article on the front page that said, "Look up, New York City, see what happened to Blackwell, OK."

My point in saying that was that we found to be successful, we had to attract small business. Without the help of the SBA and industrial revenue bonds and everything we had available to us, we wouldn't be there. The first issue would have been correct. Not to say that the SBA doesn't need modification. I think there's things that we could all suggest to improve its profitability and, therefore, keep it viable. But I'd like to ask you to think hard about its elimination, because it's been a tremendous value to the town that needs small business. I thank you very much.

[The prepared statement of Mr. Rodgers follows:]

PREPARED STATEMENT OF WILLIAM W. RODGERS, CHAIRMAN OF THE BOARD, SECURITY BANK & TRUST CO., BLACKWELL, OK

The following is a brief outline of my comments and observations relating to President Reagan's Tax Proposal and recently passed H.R. 3838 as they effect the banking industry.

I. Introduction
    A. Issues directly effecting the banking industry
        1. Repeal of the bad debt reserve deduction;
        2. Denial of the deduction for interest to carry tax-exempt bonds; and
        3. Elimination of the Small Business Administration (S.B.A.)
    B. The need for effective tax reform:
        1. American's have lost confidence in the present system
        2. Small business needs a tax system that will spur economic growth and capital formation.

II. Repeal of the Existing Bad Debt Reserve Deduction
    A. Explanation of Reserve Method of Accounting for Bad Debts
        1. Percentage Method
        2. Experience Method
    B. Specific Charge-off Method
    C. Reasoning Behind Repeal
        1. "Increases depository institutions after-tax income and enables them to offer lower interest rates".
        2. Allow banks to take additions to tax reserves that in fact bear no relationship to actual loan losses.
    D. Reasons to Retain Reserve Method
        1. Essential to Sound Banking.
        2. Avoid premature "charge-offs"
        3. Reserve Method is not "distortive"
        4. Senate Bill 1263 (Senators Roth and Boren)

   E. H.R. 3838 discriminates against large banks.

III. Denial of the Banking Industry's ability to deduct interest paid to carry tax-exempt bonds.

   A. Current law -- 20% of interest deduction denied.

   B. Two (2) important considerations:

      1. The effect upon issues of tax-exempt bonds by removing banks as prospective purchases;

      2. The effect upon banks which need to sell tax-exempt securities after January 1, 1986, and date of the passage of the new tax bill.

   C. Issuers of tax-exempt bonds will pay a higher price.

   D. Bank customers including small business will be adversely effected.

   E. Amendment needed

IV. Elimination of Small Business Administration

   A. A personal viewpoint based on experience in financing small business in Blackwell, Oklahoma

My comments will address issues contained in the following chapters of The President's Tax Proposals to Congress for Fairness, Growth, and Simplicity (May, 1985) and sections of House Bill, H.R. 3838 (December, 1985)

1. President's Tax Proposals
    - Chapter 8 - Measure Income Property
        - Chapter 8.04 -- Repeal Reserve Method for Bad Debt Reserve
    - Chapter 10 - Reform Taxation of Financial Institutions
        - Chapter 10.01 -- Repeal Special Rules for Depository Institutions Bad Debt Deductions
        - Chapter 10.02 -- Deny Deduction for Interest to Carry Tax-Exempt Bonds
        - Chapter 10.5 -- Repeal Special Rules for Net Operating Losses of Depository Institutions
2. H.R. 3838
    - Section 801 - Repeal of Bad Debt Reserve
    - Section 802 - Denial of Deduction for interest to carry tax-exempt bonds

The banking industry certainly agrees with President Reagan's concept that the current tax system is unfair, too complicated and impedes economic growth. Our industry supported fully the President's effort to curb inflation and reduce income taxes. We would now support a change in the present tax system which would increase the public's perception of fairness in our tax code and would increase investments in small business.

The success of small business depends upon an expanding economy that is not overburdened by taxes. It is important that our tax system provides incentives to encourage investments and capital formations.

The American people have lost confidence in our present tax system. Our tax code and regulations have become so complicated that it has encouraged "cheating". Bankers salute President Reagan's attempt to change our present tax system.

I do respectfully submit, however, that there are several provisions contained in the President's Proposal that were later adopted by the House of Representatives in H.R. 3838 that have a negative impact on the banking industry and should be removed. My remaining comments reflect on these issues:

(1) Repeal of the Existing Bad Debt Reserve Deductions: The current income tax laws provide for the reserve method of accounting for bad debts for all taxpayers. (I.R.C. Sec 166(c)) Section 585 of the Code provides that banks who elect under Section 166(c) to use the reserve method for bad debts use either the percentage method or the experience method to determine bad debt deductions.

The President's Proposal and H.R. 3838 would change existing law by using only the specific charge-off method for computing the deduction for bad debts. The President's Proposal (Chapter 8.04) would require all banks to use the specific charge-off method and would eliminate all reserve methods of computing bad debt reserves. H.R. 3838 would allow banks to continue under present reserve methods if their assets or the assets of their holding companies were under $500 million.

The basic reasoning behind the proposed changes are as follows:

(a) The reserve method allows an accelerated, current deduction for future loan losses, without any discount for the present value of such losses;

(b) The reserve method allows banks to defer taxable income which either "increases depository institutions after-tax income or enables them to offer lower interest rates";

(c) The reserve method allows banks to compute additions to tax reserves that in fact bear no relationship to actual loan losses.

Bankers strongly believe that the maintenance of adequate loan loss reserves is an essential aspect of sound banking. The reserve enables banks to accurately reflect the current value of their loan portfolios. Other agencies within the federal government understand the value of the reserve method and require its use. Some of these agencies are the Securities and Exchange Commission, Comptroller of the Currency, Federal Reserve Board and the Federal Deposit Insurance Corporation.

The specific charge-off method creates an incentive in the tax code to write off troubled credits in order to receive a tax decution. The true purpose of a reserve for bad debts is to cover current losses which, for valid business purposes, have not been written off at year end. For example, the present poor condition of the farm economy has made it difficult for many farmers to pay back their losses. Unfortunately, banks in many cases cannot determine which will succeed and which will not. The bank does know, however, that the value of its collateral has diminished significantly. The reserve method allows a bank to recognize the decline in value of its farm loans without having to identify which particular loan will not be paid.

The President's Proposal states by using Section 585, banks' reserve for bad debts are "overstated" and "distortive". A bank using the percentage method is allowed 0.6% of its loans in its bad debt reserve; while a bank using the experience method can have a bad debt reserve equal to its actual charge-offs averaged over the last 6 years. The truth is that in many states, especially Oklahoma, the bad debt reserve today is hardly adequate to meet the many loan problems facing banking due to the poor economic conditions existing in the energy and agricultural industries. We would have to go back to 1976 or 1977to find a significant number of Oklahoma banks that had tax reserves larger than needed reserves for book and regulatory purposes. We simply are not hiding income in our reserve for bad debts.

H.R. 3838 discriminates among banks according to asset size for purposes of the loan loss reserve deduction. Banks with assets under $500 Million are permitted to use the reserve methods while those above cannot. Such an approach runs counter to the fundamental concepts that gave rise to the entire tax reform effort -- fairness. The need for adequate reserves to insure safe and sound banking operations is the same for all banks regardless of size.

I strongly believe that the reserve method of determining bad debt reserves must be retained. Banking has, in fact, endorsed Senate Bill 1263 introduced by senators William Roth and David Boren that requires conformity between the loan loss reserve accounts maintained by banks for tax purposes and those used for financial statement purposes.

The maintenance of adequate loan loss reserve promotes the safety and soundness of the banking industry and best measures true bank income.

(2) Denial of the Banking Industry's Ability to Deduct Interest Paid to Carry Tax-Exempt Bonds: Current law provides that financial institutions are denied 20% of their net interest deduction allocable to the purchase or carrying of tax-exempt obligations acquired after 1982. The allocable portion is presumed to be the ratio of tax-exempt assets to total bank

deposits. Prior to 1982 banks were allowed to deduct all their interest expenses. Most all of a bank's interest expense is the interest it pays on customers' deposits.

The President's Proposal and H.R. 3838 (Section 802) denies any deduction of interest cost on deposits used to purchase tax-exempt obligations. Bonds acquired before January 1, 1986, would be excempt.

In considering the effect of a new law denying deductibility, two important questions are germane:

(a) Does it serve the American taxpayer to effectively remove banks as a major purchaser of tax-exempt bonds?

(b) How much harm will be caused by retroactively setting the date for enforcement of the new law on January 1, 1986, rather than the effective date of the new tax reform bill?

The President's Proposal states that the impact on the interest rates of tax-exempt securities is "uncertain". It does seem logical, though, that if banks comprise approximately 1/3 of the total market for tax-exempt securities (See Proposal Table 10.02-1), issuers will have to look elsewhere for new purchasers, or significantly increase the interest rates they are willing to pay. As a direct result of this law, many communities will be forced to pay a much higher price to get funds to build the capital improvements needed in their communities.

The proponents of Section 802 of H.R. 3838 say it will force banks to pay a greater and more fair share of the tax burden. It should be remembered that corporations, including banks, will pass if possible all new cost along to their customers. Banks will pass much of this new tax burden along to their customers in the form of higher service fees and interest rates in order to remain profitable. By rejecting Section 802 you will be aiding our communities by making their bonds less expensive to market and our banking customers by lowering their cost of financial services.

If you do choose to keep Section 802, I urge you to insert the following amendment:

"The 100% disallowance should not apply to any tax-exempt obligations acquired from a bank (as defined in Section 581) and which have been continuously held by a bank since the date of the tax reform bill."

This amendment will eliminate significant transition problems for the banking industry. The amendment will help a troubled bank find a market for its tax-exempt obligations. A bank encountering loan loss problems may find it necessary to sell its tax-exempt portfolio and replace them with taxable investments paying a higher interest rate. Section 802 would seriously jeopardize the liquidity of tax-exempt obligations by preventing their sale to other banks since that sale would be after January 1, 1986.

There should be no revenue loss from the suggested amendment since the revenue estimates assume any revenue gain from banks will be offset by revenue loss from individuals.

(3) Elimination of the Small Business Administration: The new tax reform act proposes to eliminate the S.B.A. My comments here reflect only my personal experiences with the S.B.A. and its value as an aid to small business.

In 1972, the largest industry in Blackwell announced the layoff of approximately 825 employees. In a town with a total population of only 8500, this announcement was a tremendous blow. However, with the help of the S.B.A. we were able to attract many small businesses and prevent economic disaster.

The S.B.A. has made it possible for many small businesses to receive financing which otherwise could not be obtained. The elimination of the S.B.A. will leave a financing void which will cost jobs and hamper small business from playing an important role in expanding our economy.

Senator NICKLES. Mr. Rodgers, I appreciate your comments. I'll make just one general comment alluding to your statement concerning the effective date. Myself and others in the Senate passed a resolution that said the effective date would not be before January 1, 1987, if there is a tax bill, because we do realize that there's a great deal of uncertainty any time that Congress is taking up a tax bill, and there is a lot of negative impact from that uncertainty. And so I think whether you're talking about issuing tax-exempts or whatever, we're going to try and make everything prospective and not retroactive.

Mr. RODGERS. That would help a great deal.

Senator NICKLES. Thank you.

Next Mr. Jenkins, and, Roger, you want to come up and join the panel, too?

Scott, go ahead.

STATEMENT OF SCOTT JENKINS, VICE PRESIDENT FOR EXTERNAL AFFAIRS—OKLAHOMA, WEYERHAEUSER CO., WRIGHT CITY, OK

Mr. JENKINS. Good afternoon, Senator Nickles, ladies and gentlemen. I am Scott Jenkins, vice president of our Oklahoma operations for Weyerhaeuser Co. And I thank you for the opportunity to share our views on H.R. 3838, formally referred to as the Tax Reform Act of 1985, which recently passed the House of Representatives. For southeastern Oklahoma, this legislation is not tax reform. It's a disaster, and I repeat, it's a disaster. Our southeastern Oklahoma operations mirror Weyerhaeuser Co.'s overall integrated forest operations. Basically we convert forest resources into products that compete in the international market.

The key ingredients here as elsewhere are basic timber resources, large capital investment in manufacturing facilities, and people. Our Oklahoma operations include a large resource base in land and timber. We have 870,000 acres on which intensive high-yield forestry is practiced and managed. These same lands are used by ranchers for cattle grazing. We have three major manufacturing complexes, one a Wright City, which manufactures pine and hardwood lumber, and plywood; at Valliant where containerboard and corrugated medium are produced; and at Craig where medium density fiberboard is produced. We have, as I say, a substantial direct and indirect employment base where we have 1,550 full-time jobs with a payroll of $45 million, and we have about 800 full-time jobs for service-related contractor employees. We have about 500 jobs annually for tree planting-type activities, and about $120 million is spent for operating our facilities, much of which stays in the State of Oklahoma.

Now, that's sort of a summary of what we are, and some people say that's a large corporation, and some people say that's a small corporation. Let me talk about H.R. 3838.

In general, H.R. 3838 seeks to lower overall tax rates, the primary beneficiaries of which are individuals and corporations in the retail, service, and high-tech sector. To provide funds for the tax rate reduction, H.R. 3838 first imposes broad-based penalties on all capital-intensive industries. The largest amount of these penalties falls squarely on the investing—on those investing heavily in machinery and equipment. H.R. 3838 imposes additional penalties on specific industries, timber being one of those singled out.

As a company which shares very heavily in the broad-based penalties on capital-intensive industries, the results are staggering. Increased taxes over the next 5 years would exceed one-half billion dollars. In case you might think that we aren't paying taxes now, our 1985 annual report will be out shortly, and it will show that we have paid Federal income tax rate for 1983, 1984, and 1985 of approximately 20 percent. It will exceed 20 percent. The range for those high years was 27.5, which was 1984; and 16.9 in 1983, which was a recessionary recovery year.

I'd like to now discuss the two issues that I brought up previously in a little more detail. The first is the broad-based capital formation penalties, and what they mean. H.R. 3838 would repeal outright the 10-percent investment tax credit on new machinery and equipment. Additionally the accelerated cost recovery would be replaced with a new system which would provide for much slower depreciation recoveries over a long period of time, and for us that means about twice as long.

What do these changes mean? One, it means significantly raising the cost of capital for maintaining, modernizing, and expanding facilities. These changes would increase the company's tax by well over $300 million over the next 5 years.

No. 2, it would substantially decrease our ability and other basic industries' ability to compete in world markets. And, as you know, we're already having trouble competing in world markets. These changes would make our cost recovery system dead last among industrial nations at a time when our balance of payments is already in trouble. I think the United States is already—is fifth at the present time and would go dead last. Because of the strength of the United States dollar, the forest product industry in the United States is currently facing extreme competition from foreign producers, I won't mention all of them, but Canada, Scandinavia, and Brazil are among the top ones.

And, third, southeastern Oklahoma will share in these effects ultimately affecting jobs here at home and in southeastern Oklahoma.

So, the section I just covered for the heavy industry/large industry, the impact on us is over $300 million in taxes. Now, for the timber specific penalties and what they mean.

First, timber capital gains. Since 1944, all timber owners have been entitled to capital gains treatment on the harvest and selective sale of timber. Section 631 was specifically enacted to recognize the fact that timber is a classic capital asset, requiring a large upfront investment accompanied by substantial amounts of risk, both physical and economic, over extended periods of time. H.R. 3838 would repeal timber capital gains treatment outright for corporations while retaining it for individuals. Thus, for corporations the tax rate on timber income would increase from approximately 28 percent under the current law to 36 percent, while the tax rate on other corporate income under H.R. 3838 would decrease. While capital gains treatment would be retained for individuals, the tax rate would also increase from a maximum rate under the current law of 20 percent to approximately 22 percent.

The second point is timber management and protection costs, property tax, and interest.

Since the very inception of income tax in 1913, timber owners' forest management and protection costs and property taxes and interest have been deductible as they have been for all other taxpayers. H.R. 3838 would now require all timber owners to capitalize these costs, including interest on debt the timber owner has up to the basis in the timber. Small owners, less than 50,000 acres, could elect to amortize this capital in the full amount over 5 years, while those owning between 50,000 and 75,000 acres would only be able to amortize a portion of theirs. And other timber owners would only be able to recover the capitalized amount as the timber is harvested or sold.

And, third, as a note, the small landowners 10-percent reforestation credit and 7-year amortization provision for up to $10,000 of reforestation cost per year would be repealed under H.R. 3838.

What do these timber changes mean? In general, the rate of return on existing timber investment would decrease dramatically, encouraging timber owners to liquidate their investments. And we're here today to talk about small business, and I need to say this: If we were operating under H.R. 3838 at the present time, the small people that service the wood products industry, I can't say exactly what they'd do, but I know what we would do. We'd be cutting the forest, our forest and liquidating the asset off of our land base. At the present time, about 30 percent of our material comes from other people, the small businessmen in the area. So we would drastically impact him, because we'd have to liquidate these assets off of our land. So, that's the first point. We would liquidate a lot of our investment.

The second point is at the same time, the capitalization requirements would penalize timber owners who continue to carry their investment, adding additional incentive for timber owners to liquidate their holdings even if sound forestry practices would dictate otherwise. Additionally these provisions would penalize most those owners who manage their holdings intensively. And, as you know, Weyerhaeuser Co. has over a number of years practiced high-yield forestry where some other forest products companies did not. We believe in replanting the forest 1 year after we cut the forest. Other companies didn't do it that way, and this law would make a lot of people go that way.

In the short run—the third point. In the short run, timber values would be destroyed to the detriment of all people who are selling wood products or timber. With the reduced rate of return and lowering of values, substantially more acres would be wasted and be harvested as wood fiber. Many acres would simply become uneconomical to harvest. Fifth, these changes would significantly impede the flow of new capital into the timber growing industry. The change to the timber capital gains and the requirement to capitalize forest management and protection costs and property taxes and interest expense for a full rotation, which in our case is about 35 years, would cause many timber investments to make little or no economic sense.

And, sixth, this legislation constitutes a massive breach of faith in our opinion with those owners who have made long-term timber investments, such as Weyerhaeuser, in reliance on current tax law treatment. This massive breach of faith would similarly dissuade future investors in timber from making such investments.

Some specifics of how this would affect our company: These timber changes would cost our company in excess of $150 million over the next 5 years. Now, this is just the special treatment that is given toward the forest products industry. Second, we would eliminate—we would estimate that the continued intensive high-yield forest management on over half of Oklahoma acres would be questionable. In other words, we would not practice—I don't think we would practice high-yield forestry on at least half, and maybe three-quarters of the acres in Oklahoma. For those acres we would continue to manage, the intensity of the management would be significantly lower.

The net results for southeastern Oklahoma would be less forest-related employment now and substantial declines in timber resources in the future, coupled with an increasingly depressing effect on our forest-related and regional economy.

I don't know whether you're familiar with it or not, but over the last 5 years, the forest products industry has been in a depressing mode, anyway. And this would only further our problems. So, what we're asking is that when the Senate takes action on tax reform this spring, we urge all of you here today to support retaining the fair tax treatment for timber owners under the current law and minimize changes which penalize basic industry.

As we've been saying for some time, an individual without a job doesn't benefit from a tax cut. We think this is a very important issue for southeastern Oklahoma. We thank you again for letting us testify at this hearing.

[The prepared statement of Mr. Jenkins follows:]

PREPARED STATEMENT OF SCOTT JENKINS, VICE PRESIDENT FOR EXTERNAL AFFAIRS—OKLAHOMA, WEYERHAEUSER CO., WRIGHT CITY, OK

GOOD AFTERNOON SENATOR NICKLES, LADIES AND GENTLEMEN. I AM SCOTT JENKINS, WEYERHAEUSER COMPANY VICE PRESIDENT OF OUR OKLAHOMA OPERATIONS. THANK YOU FOR THE OPPORTUNITY TO SHARE OUR VIEWS ON H.R. 3838, THE TAX REFORM ACT OF 1985, WHICH WAS RECENTLY PASSED BY THE HOUSE OF REPRESENTATIVES. FOR SOUTHEASTERN OKLAHOMA, THIS LEGISLATION IS NOT TAX REFORM--IT'S "DISASTER."

OUR SOUTHEASTERN OKLAHOMA OPERATIONS MIRROR WEYERHAEUSER'S OVERALL INTEGRATED FOREST OPERATIONS. BASICALLY, WE CONVERT FOREST RESOURCES INTO PRODUCTS THAT COMPETE IN INTERNATIONAL MARKETS. THE KEY INGREDIENTS HERE, AS ELSEWHERE, ARE THE BASIC TIMBER RESOURCE, LARGE CAPITAL INVESTMENTS IN MANUFACTURING FACILITIES AND PEOPLE.

OUR OKLAHOMA OPERATIONS INCLUDE:

- A LARGE RESOURCE BASE
  - 870,000 ACRES ON WHICH INTENSIVE, HIGH-YIELD FOREST MANAGEMENT IS PRACTICED. THESE SAME LANDS ARE ALSO USED BY RANCHERS UNDER GRAZING LEASES.
- THREE MAJOR MANUFACTURING COMPLEXES
  - WRIGHT CITY, WHERE PINE AND HARDWOOD LUMBER AND PLYWOOD ARE PRODUCED,
  - VALLIANT, WHERE CONTAINERBOARD AND CORRUGATED MEDIUM ARE PRODUCED, AND
  - CRAIG, WHERE MEDIUM DENSITY FIBREBOARD IS PRODUCED.
- A SUBSTANTIAL DIRECT AND INDIRECT EMPLOYMENT BASE
  - 1650 FULL-TIME JOBS WITH A PAYROLL OF $45,000,000.

- About 800 full-time jobs for service contractor employees.
- 500 part-time jobs annually for tree planters.
- $120 million per year is spent operating our facilities, a good portion of which stays in Oklahoma.

Now, let's talk about H.R. 3838. In general, H.R. 3838 seeks to lower overall tax rates, the primary beneficiaries of which are individuals and corporations in the retail, service and high-tech sectors of the economy. To provide funding for the rate reductions, H.R. 3838 first imposes broad-based penalties on all capital intensive industries. The largest amount of these penalties falls squarely on those investing heavily in machinery and equipment (approximately $145 billion over five years). H.R. 3838 then imposes additional penalties on specific industries, timber being one of those singled out. As a company which shares very heavily in the broad-based penalties on capital intensive industries who then is singled out for industry specific penalties, the results are staggering--increased taxes over the next five years exceeding one-half billion dollars. In case you might be thinking that maybe we aren't paying taxes now, our 1985 annual report, which will be released shortly, will show an average effective current federal income tax rate for 1983, 1984 and 1985 in excess of 20%--ranging from a high of 27.5% in 1984 to a low of 16.9% in 1983, a recession recovery year.

The broad-based capital formation penalties and what they mean.

H.R. 3838 would repeal outright the 10% investment tax credit on new machinery and equipment. Additionally, the accelerated cost recovery system (ACRS) would be replaced with a new system which would provide for much slower depreciation recoveries over longer periods of time (over twice as long in our case). What would these changes do?

- SIGNIFICANTLY RAISE THE COST OF CAPITAL FOR MAINTAINING, MODERNIZING AND EXPANDING OUR FACILITIES. THESE CHANGES WOULD INCREASE THE COMPANY'S TAXES BY WELL OVER $300 MILLION OVER THE NEXT FIVE YEARS.

- SUBSTANTIALLY DECREASE OUR ABILITY AND ALL OTHER BASIC INDUSTRIES' ABILITY TO COMPETE IN WORLD MARKETS. THESE CHANGES WOULD MAKE OUR COST RECOVERY SYSTEM DEAD LAST AMONG INDUSTRIALIZED NATIONS AT A TIME WHEN OUR BALANCE OF PAYMENTS IS ALREADY IN TROUBLE. BECAUSE OF THE STRENGTH OF THE U.S. DOLLAR, THE FOREST PRODUCTS INDUSTRY IN THE U.S. IS CURRENTLY FACING EXTREME COMPETITION FROM FOREIGN PRODUCERS, SPECIFICALLY CANADIAN, SCANDINAVIAN AND BRAZILIAN TO NAME A FEW.

- SOUTHEASTERN OKLAHOMA WILL SHARE IN THESE EFFECTS--ULTIMATELY AFFECTING JOBS RIGHT HERE AT HOME.

THE TIMBER SPECIFIC PENALTIES AND WHAT THEY MEAN.

TIMBER CAPITAL GAINS:

SINCE 1944, ALL TIMBER OWNERS HAVE BEEN ENTITLED TO CAPITAL GAIN TREATMENT ON THE HARVEST OR SELECTIVE SALE OF TIMBER. SECTION 631 WAS SPECIFICALLY ENACTED IN RECOGNITION OF THE FACT THAT TIMBER IS A "CLASSIC CAPITAL ASSET"--REQUIRING A LARGE UP-FRONT INVESTMENT ACCOMPANIED BY SUBSTANTIAL AMOUNTS OF RISK, BOTH PHYSICAL AND ECONOMIC, OVER EXTENDED PERIODS OF TIME. H.R. 3838 WOULD REPEAL TIMBER CAPITAL GAIN TREATMENT OUTRIGHT FOR CORPORATIONS WHILE RETAINING IT FOR INDIVIDUALS (NONFEDERAL TIMBER ONLY). THUS, FOR CORPORATIONS THE TAX RATE ON TIMBER INCOME WOULD INCREASE FROM 28% UNDER CURRENT LAW TO 36% WHILE TAX RATES ON OTHER CORPORATE INCOME UNDER H.R. 3838 WOULD DECREASE. WHILE CAPITAL GAIN TREATMENT WOULD BE RETAINED FOR INDIVIDUALS, THE TAX RATE WOULD ALSO INCREASE FROM A MAXIMUM RATE UNDER CURRENT LAW OF 20% TO 22%.

TIMBER MANAGEMENT AND PROTECTION COSTS, PROPERTY TAXES AND INTEREST:

SINCE THE VERY INCEPTION OF THE INCOME TAX IN 1913, TIMBER OWNERS' FOREST MANAGEMENT AND PROTECTION COSTS, PROPERTY TAXES AND INTEREST HAVE BEEN DEDUCTIBLE, AS THEY HAVE BEEN FOR ALL OTHER TAXPAYERS. H.R. 3838 WOULD NOW REQUIRE ALL TIMBER OWNERS TO CAPITALIZE THESE COSTS, INCLUDING INTEREST ON ANY DEBT THE TIMBER OWNER HAS UP TO THE BASIS IN THE TIMBER. SMALLER OWNERS (50,000 ACRES OR LESS) COULD ELECT TO AMORTIZE THE CAPITALIZED AMOUNTS IN FULL OVER FIVE YEARS, WHILE THOSE OWNING BETWEEN 50-75,000 ACRES WOULD ONLY BE ABLE TO AMORTIZE A PORTION OF THEIRS. OTHER TIMBER OWNERS WOULD ONLY BE ABLE TO RECOVER THE CAPITALIZED AMOUNTS AS TIMBER IS HARVESTED OR SOLD.

REFORESTATION CREDIT AND AMORTIZATION:

THE SMALL LANDOWNER 10% REFORESTATION CREDIT AND SEVEN-YEAR AMORTIZATION PROVISION FOR UP TO $10,000 OF REFORESTATION COSTS PER YEAR WOULD BE REPEALED.

WHAT DO THESE "TIMBER" CHANGES MEAN?

IN GENERAL

- THE RATES OF RETURN ON ALL EXISTING TIMBER INVESTMENTS WOULD DECREASE DRAMATICALLY, ENCOURAGING TIMBER OWNERS TO LIQUIDATE THEIR INVESTMENTS.

- AT THE SAME TIME, THE "CAPITALIZATION REQUIREMENTS" WOULD PENALIZE TIMBER OWNERS WHO CONTINUE TO CARRY THEIR INVESTMENTS, ADDING ADDITIONAL INCENTIVE FOR TIMBER OWNERS TO LIQUIDATE THEIR HOLDINGS, EVEN IF SOUND FORESTRY PRACTICES WOULD DICTATE OTHERWISE. ADDITIONALLY, THESE PROVISIONS WOULD PENALIZE MOST THOSE OWNERS WHO MANAGED THEIR HOLDINGS INTENSIVELY.

- In the short run, timber values would be destroyed to the detriment of all owners.

- With the reduced rates of return and lowering of values, substantially more acres would wastefully be harvested to provide a commensurate amount of wood fiber. Many acres would simply become uneconomical to harvest.

- These changes would significantly impede the flow of new capital into timber growing investments. The changes to timber capital gains and the requirement to capitalize forest management and protection costs, property taxes and interest expense for a full rotation (35 years in Oklahoma), would cause many timber investments to make little or no economic sense.

- This legislation constitutes a "massive breach of faith" with those owners who have made long-term timber investments in reliance on current law tax treatment. This massive breach of faith would similarly dissuade future investors of timber from making such investments.

Weyerhaeuser specific

- These "timber" changes would cost our company in excess of $150 million over the next five years.

- We estimate that continued intensive, high-yield forestry management on over half of our Oklahoma acres would be questionable. For those acres we would continue to manage, the intensity of management would be significantly lower.

- The net result for Southeast Oklahoma--

- LESS FOREST RELATED EMPLOYMENT NOW AND
- SUBSTANTIAL DECLINES IN TIMBER RESOURCES IN THE FUTURE, COUPLED WITH AN
- INCREASINGLY DEPRESSING EFFECT ON OUR "FOREST-RELATED" AND REGIONAL ECONOMIES.

WHEN THE SENATE TAKES ACTION ON "TAX REFORM" THIS SPRING, WE URGE ALL OF YOU HERE TODAY TO SUPPORT RETAINING THE FAIR TAX TREATMENT OF TIMBER OWNERS UNDER CURRENT LAW AND MINIMIZING THE CHANGES WHICH PENALIZE BASIC INDUSTRIES. AS WE'VE BEEN SAYING FOR SOME TIME, "AN INDIVIDUAL WITHOUT A JOB DOESN'T BENEFIT FROM A TAX CUT." WE THINK THIS IS A VERY IMPORTANT ISSUE FOR SOUTHEAST OKLAHOMA.

THANK YOU.

Senator NICKLES. Mr. Jenkins, thank you for your statement and also for your willingness to come from McCurtain County. That's a long way to come, especially with the weather, so I appreciate your participation.

The next panelist we have is Thomas Stephens, vice president and treasurer of Kerr-McGee.

STATEMENT OF THOMAS B. STEPHENS, VICE PRESIDENT AND TREASURER, KERR-McGEE CORP., OKLAHOMA CITY, OK

Mr. STEPHENS. Senator Nickles, ladies and gentlemen, thank you very much for affording Kerr-McGee Corp. the opportunity to submit its views on the two tax reform proposals currently under debate.

A great amount of research studies have been prepared by now by various industry trade groups, public accounting firms, and agencies of both the Federal and various State governments to show the effects of both H.R. 3838 and the President's proposal, tax reform for fairness, simplicity, and economic growth. Some of these studies are listed in an exhibit A prepared for the committee, and I will not go into them further at this time.

One study I would like to mention, however, is a study prepared in 1984 by the staff of the Joint Committee on Taxation for Congressman Peace of Ohio and Dorgan of North Dakota. This study indicated that while effective tax rates for taxes currently payable vary widely from industry group to industry group and even from year to year within the same industry group, the petroleum industry had a higher effective tax rate that the 30 industry groups as a whole on the basis of both U.S. tax rate on U.S. income and worldwide tax rate on worldwide income for all years covered by the study, 1980 through 1983.

In 1983, for example, the petroleum industry had an effective tax rate based on U.S. income of 21.3 percent for taxes currently payable, versus an average for the other 29 industry groups of 15.4 percent. On a worldwide basis, the difference is even greater, a 42-percent effective tax rate for the petroleum industry versus an average of 23.6 percent for the other 29 industry groups. This data is summarized in table 1 of our paper.

In addition, the petroleum industry pays a large number of taxes not paid by other industries generally, such as the Superfund tax, windfall profits tax, and excise taxes on various fuels. These taxes are considerable. Both tax reform proposals under consideration would have an adverse effect on Kerr-McGee. The proposed reductions in corporate tax rate and the dividends paid deduction are inadequate to compensate for the detrimental effects due to the loss of investment tax credit, repeal or reduction in percentage depletion on coal and other hard minerals, and the recapture tax or clawback on previously taken depreciation contained in the President's proposal or the reduction in depreciation due to greatly increased recovery periods under H.R. 3838. Neither proposal is revenue neutral.

Based upon our forecasts for the 4-year period, 1986 to 1989, H.R. 3838 would result in an increase in Federal income taxes payable of approximately $17.4 million in 1986, and approximately $36.7 million over the full 4-year period. The President's proposal would have a slightly lesser detrimental effect, $28.6 million over the 4-year period, but a substantially greater effect in the first year, $22.6 million due principally to the retroactive clawback of previously taken depreciation.

The details of the major changes in Federal income taxes payable by Kerr-McGee under the two tax reform proposals are given in table 2 of our paper.

In addition to the major provisions of the tax reform proposals affecting Kerr-McGee listed in table 2, other provisions which would have lesser effects or which could have a major effect under certain circumstances would be increases in the minimum tax, changes in the method of computing foreign tax credits, repeal of the reserve method for bad debts, and recapture of intangible development costs on mining properties later placed into production.

Since Kerr-McGee has budgeted capital expenditures for several years, and will continue to budget them for the foreseeable future, it cannot exceed available cash flow after dividends. Any increase in taxes with a resulting decrease in cash-flow will cause a further reduction in capital expenditures.

In the invitation to appear at this hearing, it was stated that it was the committee's desire to investigate the effects of the two tax reform proposals currently under discussion upon small business. While Kerr-McGee is certainly not a small business, the effects on Kerr-McGee are no different that the effects would be on a small business in the same industries as are we. In fact, the detrimental effects on a small business of the triggering of the minimal tax in a marginal year would undoubtedly be more severe on such a business than on Kerr-McGee which has greater financial and operating flexibility to carry it through to better times.

To assess the negative impact of either of the two tax reform proposals on future capital investment and ultimately on jobs created, it is not sufficient to analyze the effects of these two proposals on corporations as they increase taxes based on existing business alone.

Corporations make investment decisions based on the expected future economic return of such investments, after taxes. It is in this area, capital formation and investment, that both tax reform proposals are terribly deficient and shortsighted. The paper prepared for the committee contains a very brief discussion of the way businesses analyze investments based on their discounted cash-flows after taxes, and I shall not repeat the discussion here.

To determine the effects of both tax reform proposals on investment decisions as they might affect a company such as Kerr-McGee, we prepared under current tax law standard discounted cash-flow analyses of two different prototype investments which we might have an occasion to consider. The provisions of both tax reform proposals were then applied to these projects to determine the detrimental effects of these proposals.

The first prototype investment was a hypothetical investment in a refining project with a 20-year economic life. A series of cash-flows were simulated to yield 15 percent after-tax discounted rate of return over the life of the project. As discussed in the paper, a 12.5- to 15-percent rate of return is normally considered to be about a minimum acceptable return for a capital investment depending upon the degree of risk involved. The provisions of each tax reform proposal were then applied to these simulated cash-flows to arrive at the new rate of return should either of the tax reform proposals become law and all other factors remain constant. The results are shown in table 3 of the paper.

The provisions of the President's proposals lower the rate of return of this hypothetical project from 15 to 13.9 percent; while the provisions of H.R. 3838 would have an even more detrimental effect, lowering the rate of return to 12.4 percent.

The second investment analyzed is the possible actual investment in a mining venture with an estimated 28-year economic life. As shown in table 3, this project has a rate of return of 12.7 percent under current tax law, which might make it fairly acceptable as a project to pursue. Both tax reform proposals lower the rate of return substantially, to 10.3 percent in the case of the President's proposal and to 9.4 percent in the case of H.R. 3838. And both make the project uneconomic to pursue.

This project would provide employment for approximately 450 people during both the development stage of 3 to 4 years and during the operations stage thereafter.

As mentioned earlier, the President's tax reform proposals would have a substantial negative impact on Kerr-McGee in the first year due to the provision for a retroactive clawback of depreciation taken during the period 1981 to 1985 under provisions of the Economic Recovery Tax Act of 1981.

The accelerated depreciation provisions of this act, the accelerated cost recovery system, or ACRS, were enacted to stimulate capital investment. It is well-recognized and documented by ample statistics that capital expenditures for the U.S. economy as a whole for the first several quarters after the trough of the most recent recession, which occurred in the fourth quarter of 1982, a little more than a year after passage of the 1981 Tax Act, occurred at a substantially greater rate than during comparable periods of previous post-World War II recoveries. Thus, if any provision of the 1981 Tax Act achieved the intended results, it was the ACRS provisions for cost recovery. Table 4 in our paper provides data for real fixed nonresidential investment for the current recovery and for five previous recoveries since 1951. The recovery of 1981 has been deleted because of its brief duration. It is obvious from data in this table that capital investment in the most recent recovery was substantially in excess of that experienced in previous recoveries. By the eight quarter following the end of the recession in the fourth quarter of 1982, real fixed nonresidential investment had reached 132 percent of the amount achieved during the trough quarter versus an average for the five previous recoveries of only 114 percent of the amount in the previous trough.

This rapid expansion of real fixed nonresidential investment was achieved with less inflation than that experienced during previous expansions. By the eighth quarter following the most recent trough in the fourth quarter of 1982, the producer price index had increased by only 3 percent over its level in the trough quarter versus an average of the five previous recoveries over the same relative time periods of 4.4 percent. This data is also presented in table 4.

Congress should not forget its own recent successes so quickly. Enactment of a retroactive clawback of the type proposed in the President's tax reform proposal would be unprecedented and long remembered. If such a retroactive clawback provision is enacted, it is unlikely that future legislative acts passed in the trough of the next recession to stimulate the economy will have the same positive impact on investment as those enacted in the 1981 tax act.

That concludes my presentation. Thank you very much for affording us the opportunity to speak today.

[The prepared statement of Mr. Stephens follows:]

Prepared Statement of Thomas B. Stephens, Kerr-McGee Corp.

EFFECT OF TAX REFORM PROPOSALS ON NATURAL RESOURCE INDUSTRIES

Many research studies prepared by industry trade groups, professional associations such as large Public Accounting firms, and agencies of Federal and State governments have now been prepared to show the effects of both HR3838 and the Tax Reform for Fairness, Simplicity and Economic Growth proposal presented to the Congress by President Reagan. These studies all reach the conclusion that both HR3838 and the President's proposals would substantially increase the tax burden of companies engaged in the exploration for and development of the country's natural resources. President Reagan has also stated in his television speeches that HR3838 has too severe an impact on capital formation because of the extremely long lives mandated for capital recovery purposes. Both tax reform plans repeal the 10% investment tax credit provision, thereby further increasing the recovery period for capital and reducing the economic return of any new investments in plant and equipment.

A listing of some of these studies is attached on Exhibit A and they will not be discussed further here.

However, it is often alleged that the tax code subsidizes some industries at the expense of others and that one of the favored industries is the petroleum industry. The Tax Code may well contribute to different effective tax rates on different industries at

Table 1

1983 Effective Income Tax Rates for Taxes Currently Payable

	Effective U.S. Tax Rate on U.S. Income	Effective Worldwide Tax Rate on Worldwide Income
Petroleum Industry	21.3%	42.0%
29 other industry groups	15.4%	23.6%
30 industry groups including petroleum	16.7%	29.2%

Effective Income Tax Rates for Taxes Currently Payable 1980-1983

U.S. Rate on U.S. Income

	1980	1981	1982	1983
Petroleum Industry	31.1%	21.7%	18.2%	21.3%
30 industry groups including petroleum	21.8%	17.2%	16.1%	16.7%

Worldwide Rate on Worldwide Income

	1980	1981	1982	1983
Petroleum Industry	44.7%	38.0%	38.2%	42.0%
30 industry groups including petroleum	34.3%	29.6%	29.6%	29.2%

certain times, but such differences are usually the result of far more complicated factors than mere provisions of the Tax Code, and the petroleum industry is certainly not a favored industry. Data presented in Table 1 taken from a 1984 report prepared by the staff of the Joint Committee on Taxation for Congressmen Peace of Ohio and Dorgan of North Dakota indicate that on the basis of both domestic and worldwide income the effective tax rate for the petroleum industry for taxes currently payable is higher than the average for 29 other industry groups in 1983. This study also indicates that such a condition also existed in the years 1980-1982. This study, of course, does not include the substantial taxes paid by the petroleum industry, other than income taxes, such as the Windfall Profits Tax, Superfund Tax, and Federal excise taxes on fuel which do not apply to other industries generally.

THE INCREASED TAX EXPENSE FOR KERR-McGEE CORPORATION RESULTING FROM HR3838 AND THE PRESIDENT'S PROPOSALS

The President's proposals for tax reform and HR3838 both would have an adverse impact on Kerr-McGee as shown in Table 2. The proposed reductions in the Federal corporate tax rate to 33% in the President's proposal and 36% in HR3838, and the dividends paid deduction are inadequate to compensate for the detrimental effects due to the loss of investment tax credit, the repeal or reduction in percentage depletion on coal and other "hard" minerals, and the recapture tax on previously taken accelerated depreciation in the

TABLE 2

KERR-McGEE CORPORATION
COMPARISON OF HR3838 WITH PRESIDENT'S PROPOSAL
FOR THE YEARS 1986-1989
(IN THOUSANDS OF DOLLARS)

		Tax Reform Act of 1985 - HR3838		The President's Tax Proposals To The Congress for Fairness Growth and Simplicity	
		Increase (Decrease)		Increase (Decrease)	
	Effective Date	1986	1986-89	1986	1986-89
Increases in tax					
Repeal of Investment Credit	1-1-86	$11,650	$45,201	$11,650	$45,201
Phased Reduction of Mineral Percentage Depletion	1-1-86	1,875	19,403	2,165	24,706
Changes in Allowable Depreciation	1-1-86	2,560	25,573	351	1,718
Tax on "Excess Depreciation"	1-1-86	0	0	17,471	51,528
Changes in Deductibility of IDC	1-1-86	8,250	16,677	0	0
Decreases in Tax					
Partial Deduction for Dividends Paid	1-1-87	0	(1,259)	0	(5,745)
Net Reduction in Tax Rate	7-1-86	(6,917)	(68,930)	(9,018)	(88,799)
Net Increase (Decrease) in Tax		$17,418	$36,665	$22,619	$28,609

President's proposal or the reduction in depreciation due to greatly increased recovery periods in HR3838. Thus, neither proposal is even close to being "revenue neutral".

Applying the provisions of HR3838 and the President's tax reform proposals to the financial forecast of Kerr-McGee for the four-year period 1986 through 1989 results in a net increase in Federal income taxes for Kerr-McGee of approximately $17.4 million in 1986 under HR3838 and approximately $22.6 million in 1986 under the President's proposals. For the entire four year period, the net increase in Federal income taxes for Kerr-McGee under HR3838 is approximately $36.7 million and under the President's proposal approximately $28.6 million. Thus, both tax reform proposals result in a significant net increase in Federal income taxes payable by Kerr-McGee. The provisions of HR3838 have a greater impact on the Federal income tax of Kerr-McGee over the full four-year period of the forecast ($36,665,000 vs. $28,609,000) with further increases in later years, but President Reagan's proposal has the greater impact on Kerr-McGee in the first year due to the retroactive clawback of depreciation previously taken during the period 1981 to 1985 under provisions of the Economic Recovery Tax Act of 1981.

Other major provisions in these tax reform plans as they affect corporations are increases in minimum tax, changes in the computation of foreign tax credits, repeal of the reserve method for bad debts, and recapture of intangible development costs on mining properties placed into production. All of these provisions would increase taxes in varying degrees for Kerr-McGee. For example, changes in the method of computing foreign tax credits would cause an increase in Kerr-McGee's taxes if Kerr-McGee were to dividend earnings of foreign subsidiaries back to the parent company. This change would act to discourage such dividends and provide an incentive for retaining and reinvesting such earnings abroad. Another example would be that if a year of marginal or negative earnings occurred, provisions of the minimum tax could become applicable, placing a further strain on cash available for investment.

In the invitation to appear at this hearing, it was stated that it was the Committee's desire to investigate the effects of the two tax reform proposals currently under discussion upon small business. While Kerr-McGee is certainly not a small business, the effects on Kerr-McGee are no different than the effects would be on a small business in the same industries as are we. In fact, the detrimental effects on a small business of the triggering of the minimum tax in a marginal year would undoubtedly be more severe on such a small business than on Kerr-McGee which has greater financial and operating flexibility to carry it through to better times.

EFFECT OF TAX REFORM PROPOSALS ON ECONOMICS OF FUTURE CAPITAL INVESTMENT

To assess the negative impact of either of the two tax reform proposals on future capital investment it is not sufficient to analyze the effects of these two proposals on corporations as they increase taxes based on existing business alone. Corporations make investment decisions based on the expected economic return of such investments. Most investment decisions in the current age are based on discounted cash flow analysis of the investment whereby the expected cash flows of an investment, both out and in, are projected in time and discounted back to the date of the investment decision to determine if the economic return of the investment is sufficient to justify the expenditure of the funds. The necessary discounted rate of return from an investment will vary depending upon the inherent risk of the investment and to a lesser extent upon the economic environment at the time of the investment. The proper and necessary minimum return to attract investment funds to a project is often the subject of great dispute within both industry and academic circles; however, an after-tax discounted rate of return in the range of 12% to 15% is generally considered to be the minimum return acceptable to justify an investment in a project with reasonable risk in most industries at the current time. In fact, many corporations use as a "hurdle" rate for deciding whether or not to undertake an investment a 15% after-tax rate of return calculated on a discounted cash flow basis.

To illustrate the effects of both HR3838 and the President's proposal for tax reform on the discounted cash flow rate of return for an investment, we have made financial calculations on two typical investments. The results of these studies are shown in Table 3. The first such investment is a hypothetical investment in a petroleum refining project. The project is assumed to have a 20-year economic life, and equal annual cash flows were calculated to yield a 15% after-tax discounted rate of return under current tax law. Applying the provisions of the President's tax reform proposals to this investment reduces the after-tax rate of return from 15% to 13.9%. The provisions of HR3838 have an even more detrimental effect on this prototype investment, reducing the after-tax rate of return to 12.4%.

The second prototype investment is a typical project of Kerr-McGee in a mining venture. With an assumed economic life of 28 years, this investment has an after-tax rate of return of approximately 12.7%, making it perhaps barely acceptable as a project to pursue. The President's tax reform proposal would reduce the return on this investment to 10.3%. The provisions of HR3838 would further reduce the after-tax return on this investment to 9.4%. Thus, both tax reform proposals make the project uneconomic and cause cancellation of it. This project, if pursued, would result in employment for an average workforce of approximately 450 persons for approximately 3-4 years during development and approximately the same number in operations after construction is completed.

Table 3

After-Tax Discounted Cash Flow
Rate of Return

	Current Law	President's Proposal	HR3838
Hypothetical Refinery Project	15.0%	13.9%	12.4%
Actual Mining Project	12.7%	10.3%	9.4%

As mentioned earlier, the President's tax reform proposals would have a substantial negative impact on Kerr-McGee in the first year due to the provision for a retroactive clawback of depreciation taken during the period 1981 to 1985 under provisions of the Economic Recovery Tax Act of 1981 (ERTA). The accelerated depreciation provisions of this Act, the Accelerated Cost Recovery System or ACRS, were enacted to stimulate capital investment. It is well recognized and documented by ample statistics that capital expenditures for the U.S. economy as a whole for the first several quarters after the trough of the most recent recession which ended in the fourth quarter of 1982, a little more than a year after the passage of ERTA, occurred at a substantially greater rate than during comparable periods of previous post-World War II recoveries. Thus, if any provision of ERTA achieved the intended results, it was the ACRS provisions for cost recovery. Table 4 provides data for Real Fixed Non-residential Investment for the current recovery and for five previous recoveries since 1951. The recovery of 1981 has been deleted because of its brief duration. It is obvious that capital investment in the most recent recovery was substantially in excess of that experienced in previous recoveries. By the 8th quarter following the end of the recession in the 4th quarter of 1982, Real Fixed Non-residential Investment had reached 132% of the amount achieved during the trough quarter vs. an average for the five previous recoveries of 114% of the amount in the previous trough.

This rapid expansion of Real Fixed Non-residential Investment was achieved with less inflation than that experienced during previous expansions. By the eighth quarter following the most recent trough in the fourth quarter of 1982, the Producer Price Index had increased by only 3% over its level in the trough quarter vs. an average for the five previous recoveries over the same relative time periods of 4.4%. This data is presented in the lower section of Table 4.

Congress should not forget its own recent successes so quickly. Enactment of a retroactive clawback of the type proposed in the President's tax reform proposals would be unprecedented and long remembered. If the retroactive clawback provision is enacted, it is unlikely that legislative acts passed in the trough of the next recession to stimulate the economy will have the same positive impact on investment as those enacted in the Economic Recovery Tax Act of 1981.

Table 4

REAL FIXED NON-RESIDENTIAL INVESTMENT

	Current Recovery	Average of 5 Previous Recoveries*
Trough Quarter	1.00	1.00
1st Qtr. after trough	1.00	1.00
2nd Qtr. after trough	1.02	1.01
3rd Qtr. after trough	1.07	1.03
4th Qtr. after trough	1.14	1.06
5th Qtr. after trough	1.20	1.04
6th Qtr. after trough	1.26	1.11
7th Qtr. after trough	1.30	1.12
8th Qtr. after trough	1.32	1.14

PRODUCER PRICE INDEX

	Current Recovery	Average of 5 Previous Recoveries*
Trough Quarter	1.00	1.00
1st Qtr. after trough	1.00	1.01
2nd Qtr. after trough	1.00	1.01
3rd Qtr. after trough	1.01	1.02
4th Qtr. after trough	1.02	1.02
5th Qtr. after trough	1.03	1.03
6th Qtr. after trough	1.04	1.04
7th Qtr. after trough	1.03	1.04
8th Qtr. after trough	1.03	1.044

*Recoveries starting in the third quarter of 1954 and 1958, second quarter of 1961, first quarter of 1971, and second quarter of 1975.

We have had three major tax law changes in the past five years, the Economic Recovery Tax Act in 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Act of 1984. This is an unprecedented number of major changes in such a short period of time. These frequent changes have made it increasingly difficult to make reliable long term plans and therefore to plan adequately for future investment. Another element of risk has entered the picture, the risk that tax law will change materially and adversely before a long term project can even be completed, thus rendering it uneconomic from the outset. An economy plagued with a low savings rate, too much consumption at the expense of investment, average and economically outdated capital stock in far too many industrial sectors, and decreasing self-sufficiency in many vital raw materials cannot afford a tax system, including instability of it due to constant change, that discourages investment and forces increased reliance on short term goals and plans.

The present system is far from perfect, but it certainly is preferable to either the President's proposal or HR3838 on balance. If a tax reform proposal that improves on the current system cannot be drafted, the country would be better served by leaving the current system intact rather than by passing changes which will discourage investment and make it even more difficult to innovate and compete in areas of emerging technologies or to develop our natural resources as secure sources of raw materials.

EXHIBIT A

Name of Report	Tax Reform Act of 1985 - HR3838	The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity
The Economic Impact of the President's Tax Reform Proposals on the Coal Industry, Price Waterhouse, September, 1985 (Updated January, 1986 for HR3838)	Projects A 75% increase in tax burden for the coal for 1986-1990 ranging from 41% in 1986 to over 100% in 1990 when fully effective.	Projects an average 62% increase in tax burden for the coal industry for 1986-1990 with a 67.6% increase in 1990 when fully effective.
Effect of the Second Ways & Means Committee Proposal for Tax Reform on Drilling Profitability and U.S. Oil & Gas Production, Data Resources, Inc. December 10, 1985.	Projects A 27% cutback in oil and gas drilling activity by 1987 and reductions in domestic oil and gas production of 775,000 barrels per day in 1990 and 850,000 barrels per day in 1995.	
Analysis of the Impacts of the President's Tax Proposal on Major Sections of the Energy Industry, The Energy Information Administration, August, 1985.		Projects a 49 - 81% increase in taxes for coal producers over the period 1986 - 1998. Projects an overall 2.9% increase in taxes for major energy companies.
Impact of the President's Tax Reform Proposals on the United States Mining Industry, Arthur D. Little, Inc./Jones, Day, Reavis & Pogue, September, 1985.		Projects a 50% increase in tax liabilities for mining companies and a loss of 380,000 jobs in the United States.
Analysis of Proposed Tax Regulation Changes on the Domestic Mining Industry, Bureau of Mines, October, 1985.		Projects a 94% increase in net federal taxes on stand alone phosphate property, with a much higher increase in discounted dollars for property which is part of a larger corporate entity.

Senator **NICKLES**. Mr. Stephens, thank you. I appreciate your statement. I've read all the statements that were submitted to us previously, and I had read your statement. I also appreciate the accompanying charts and the amount of homework that went into it. I think that's very helpful, and especially the comparison of how the two plans or the two proposals would affect Kerr-McGee and also how that would affect your investment. That's probably the one thing that very little has been heard of. You know, a lot of individuals or companies will say, "Well, this one would increase my taxes such and such, or this one would do this much more or less." Your analysis is basically saying, we heard the same thing from Mr. Jenkins, "If this would pass, we're not going to have those investments, and you can make a direct correlation, that's a loss of jobs, that's a loss of payroll, that's a loss of taxpayers."

And I think that many times when Washington and various committees are playing with the Tax Code in looking at ways of trying to raise money from the private sector or the business sector or whatever, they're assuming that you're going to continue drilling, you're going to continue producing timber or whatever, and I think that can be very shortsighted.

I'm going to have to ask all of our panelists if we can keep our statements a little bit shorter, because we do have two other panels and we're on kind of a tight time constraint.

Next we have Roger Dahlgren with K&R Coal Co., and, Roger, we appreciate your joining us today representing Oklahoma coal producers.

STATEMENT OF ROGER E. DAHLGREN, K&R COAL CO., BETHANY, OK

Mr. **DAHLGREN**. Thank you. I'd first like to thank you, Senator Nickles, for inviting me to speak to you on these different tax proposals and the effect it will have on my company, K&R Coal Co. In comparing the President's tax proposals and the Tax Reform Act of 1985 to present law, the items affected under any or all three include the depreciation system, the repairs allowance, bonus depreciation, recapture of excess accelerated depreciation, investment tax credit, exploration and development cost, percentage depletion, corporate tax rates, corporate minimum tax rates, percentage depletions, accelerated depreciation on personal property, expensing of mining exploration and development costs, and reclamation costs.

The repeal of capital gains treatment on coal royalties won't directly affect my company. However, it may result in increased costs for future property acquisitions and interests, the property owners may try to maintain the same rate of return after taxes on their coal royalties.

Guidelines for repair allowances weren't available and, therefore, not considered in the example. Recapture of excess accelerated depreciation regards prior depreciation taken and also was not considered.

The following example shows specifically how these changes will affect my company.

As you can see in the example, everything stays the same until equipment depreciation. Then everything changes, and changes for the worst. The bottom line shows the real effects of these proposals. A possible tax liability of $192,000 in present law increases all the way to $336,000. I sure wish my income could be manipulated like these proposals with the same rate of change. But in today's coal market, that would be impossible.

Instead of changing all the tax rules which makes it impossible to make investment plans, let's just stop spending so much money. The Federal Government currently in my opinion overpays the majority of its work force. All major industries in the last 4 years have experienced substantial wage cuts. I'm sure not aware of any wage cuts taken by the civil service workers. All services provided by the Government need to be reevaluated to determine what is absolutely necessary and stop spending money on programs that are not necessary or have very little return on the money spent. The President's idea about making welfare recipients work for money they receive is an excellent proposal. The plain, simple fact is our Government spends too much money.

The Gramm-Rudman-Hollings legislation is a bill designed to accomplish exactly that, spend less money, but does it really do that? Gramm-Rudman-Hollings is a remarkable piece of legislation that's evoked a wide array of emotions ranging from wild laughter to thundering rage. First of all, Gramm-Rudman is an admission that Congress is flat unable to perform its most important duty; that is, passing a budget that balances expenditures with revenues. You don't have to be a sleuth to figure out that the boys on Capitol Hill have been messing up. Just look at the legislation that the Gramm-Rudman-Hollings was attached to, a bill to increase the Federal debt ceiling to $2 trillion. That's real good.

Senator, I have faith that you are one of the more responsible leaders in Washington who has proven himself able to make a tough political decision. My message is very simple: Stop spending borrowed money and balance the budget.

[The prepared statement of Mr. Dahlgren follows:]

PREPARED STATEMENT OF ROGER E. DAHLGREN, K&R COAL CO., BETHANY, OK

I would first like to thank you, Senator Nickles for inviting me to speak on these different tax proposals and the affects it will have on my company K & R Coal Company. In comparing the President's Tax Proposals and the Tax Reform Act of 1985 to present law, the items affected under any or all three include:

1. The depreciation system
2. Repairs allowance
3. "Bonus" depreciation
4. Recapture of excess accelerated depreciation
5. Investment Tax Credit
6. Exploration and development costs
7. Pecentage depletion
8. Corporate tax rates
9. Corporate minimum tax -
    a. Rates
    b. Percentage depletion
    c. Accelerated depreciation on personal property
    d. Expensing of mining exploration and developement costs.

10. Reclamation costs.

The repeal of capital gains treatment on coal royalties won't directly effect my Company, however, it may result in increased costs for future property acquisitions, i.e., the property owners may try to maintain the same rate of return after taxes.

Guidelines for the Repairs Alllowance weren't available and therefore, not considered in the example. Recapture of excess accelerated depreciation regards prior depreciation taken and also wasn't considered.

The following example shows sepcifically how these changes will affect my Company.

	Present Law	President's Proposals	Tax Reform Act of 1985
Gross sales	$ 6,000,000	6,000,000	6,000,000
Other income	290,000	290,000	290,000
Cost of sales	(3,670,000)	(3,670,000)	(3,670,000)
Equipment depreciation	(981,000)	(817,000)	(700,000)
Reclamation expense	(203,000)	(155,000)	(203,000)
Depletion	(376,000)	-	(258,000)
G & A expenses	(630,000)	(630,000)	(630,000)
Taxable income	$ 430,000	1,018,000	829,000
Federal tax	$ 178,000	336,000	298,000
Investment credit	(19,000)	-	-

Minimum tax	33,000	-	-
	$ 192,000	336,000	298,000

As you can see everything in the example stays the same until Equipment depreciation, then everything changes----and changes for the worst. The bottom line shows the real affects of these two proposals. A possible tax liability of $192,000 increases all the way to $336,000. I sure wish my income could be manipulated like these proposals with the same rate of change. But with todays coal market that would be impossible.

Instead of changing all the tax rules which makes it impossible to make investment plans, let's just stop spending so much money. The federal government currently in my opinion, overpays the majority of its work force. All major industries in the last four years have experienced substantial wage cuts. I am sure not aware of any wage earners of the United States, whose taxes supply the money to pay the civil service workers pay checks, not also take wage cuts? All services provided by the government need to be re-evaluated to determine what is absolutely necessary, and stop spending money on the programs that are not necessary or have very little return on the money spent. The President's idea about making welfare recipients work for the money they receive is an excellent proposal. The plain simple fact is our government spends too much money.

The Gramm-Rudman-Hollings legislation is a bill designed to accomplish exactly that, spend less money. But . . . does it really do this? Gramm-Rudman-Hollings is a remarkable piece of legislation that evokes a wide array of emotions, ranging from wild laughter to thundering rage. First of all, Gramm-Rudman-Hollings is an admission that Congress is flat unable to perform its most important duty, that is, passing a budget that balances expenditures with revenues. You don't have to be a sleuth to figure out that the boys on Capitol Hill have been messing up. Just look at the legislation that Gramm-Rudman-Hollings was attached to: a bill to increase the Federal debt ceiling to $2 trillion! Now that's a real knee-slapper.

Senator, I have faith that you are one of the more responsible leaders in Washington who has proven himself able to make tough political decisions. My message is very simple, stop spending borrowed money and balance the budget!

THE ECONOMIC IMPACT OF THE WAYS AND MEANS TAX REFORM BILL (H.R. 3838) ON THE COAL INDUSTRY

On December 17, 1985, the House of Representatives approved a tax reform bill that will have a considerable impact on the taxation of companies in the coal industry. Several sections of the current law tax code that are of direct importance to the coal industry will be significantly changed, greatly affecting the future profitability of coal companies. The following is an update to the Price Waterhouse report The Economic Impact of the President's Tax Reform Proposals on the Coal Industry, September, 1985.

This update briefly discusses those sections of the Ways and Means bill that have an impact on the coal industry along with an analysis of the projected cost of each individual provision and the bill taken as a whole. For a detailed explanation of the methodology used in this study, please refer to the earlier report.

Results of the Analysis

Table 1 presents projected tax liabilities under both current law and the Ways and Means bill. The change in tax liability over the five-year period from $2.2 billion under current law to over $3.8 billion under proposed law represents a projected 75 percent increase in taxes for the coal industry if this bill is enacted. The annual increases range from 41 percent in the first year to 100 percent in 1989. While the projections end at 1990, it is likely that future tax liabilities will be closest to those projected for the later years.

TABLE 1

PROJECTED TAX LIABILITIES
PRESENT LAW AND WAYS AND MEANS BILL
U.S. COAL INDUSTRY - 1985-1990

($ millions)

	Current Law	Proposed Law	Difference
1985	422.6	N.A.	N.A.
1986	443.2	625.5	182.3
1987	430.7	696.2	265.5
1988	427.5	757.4	329.9
1989	431.6	832.9	401.2
1990	470.4	943.2	472.8
1986-1990	2,203.4	3,855.2	1,651.7

Five-year totals of the estimated changes in tax liability attributable to each provision of the Ways and Means bill are shown in Table 2. The total increase of over $1.6 billion during the period 1986-1990 is the net effect of nine specific changes in tax law.

The year-by-year effects of each individual provision can be found in Table 3. Six of the provisions represent a significant increase in the taxation of the industry, while only one of the provisions will benefit coal companies. The six changes that will increase the taxes paid by coal companies are (1) the reduction of percentage depletion allowances over three years from the current 10 percent to the proposed 5 percent, (2) the recapture of mining development expenses when a mine begins production, (3) the repeal of the investment tax credit, (4) the change from the current Accelerated Cost Recovery System to the Incentive Depreciation System for depreciable property, (5) the change in the treatment of capital gain on depreciable assets, and (6) the change to an alternative minimum tax. The proposal that partially offsets the increase in taxes is the reduction of the corporate tax rate from 46 percent to 36 percent.

One way to assess the impact of the Ways and Means bill on the coal industry is to divide the proposals into two categories, those which affect all industries in general and those which specifically affect extraction industries. The three items that directly affect the taxation of extraction industries are (1) the repeal of percentage depletion, (2) the recapture of mining development expenses, and (3) the change in treatment of Section 1231 income. The total impact of these three items is to increase coal industry taxes by about $900 million. In other words, those items that are mining-specific account for over 50 percent of the tax increase that will be borne by the coal industry.

TABLE 2

SUMMARY OF PROJECTED FIVE-YEAR CHANGES IN TAX LIABILITIES, DUE TO WAYS & MEANS BILL

U.S. COAL INDUSTRY

($ millions)

Provision	1986-1990
Change in Depreciation Allowances	$ 447.4
Change in Depletion Allowances	764.8
Dividends Paid Deduction	-8.4
Change in Treatment of Capital Gain on Deprecible Assets	117.4
Recapture of Mining Development Expenses	93.1
Change in Treatment of Royalty Income	37.3
Decrease in Corporate Tax Rate	-809.9
Repeal of Investment Tax Credit	781.1
Change in Corporate Minimum Tax	229.1
TOTAL DIFFERENCES	$1,651.7

NOTE: Details do not add due to rounding.

TABLE 3

CHANGE IN TAX LIABILITY DUE TO WAYS & MEANS BILL, BY PROVISION,

U.S. COAL INDUSTRY

($ millions)

ELEMENTS OF TAX LIABILITY DIFFERENCES FOR ALL COMPANIES	1986	1987	1988	1989	1990	Five-Year Total
Change in Depreciation Allowances	26.3	36.0	68.5	121.5	195.1	447.4
Change in Depletion Allowances	65.1	116.4	167.1	192.7	223.5	764.8
Dividends Paid Deduction	0.0	(1.0)	(1.9)	(2.9)	(2.6)	(8.4)
Change in Treatment of Capital Gain on Depreciable Assets	23.2	22.5	22.2	23.7	25.8	117.4
Recapture of Mining Development Expenses	0.0	27.3	37.6	18.1	10.1	93.1
Change in Treatment of Royalty Income	1.0	1.4	2.8	14.7	17.4	37.3
Decrease in Corporate Tax Rate	(64.1)	(124.9)	(163.8)	(199.9)	(257.2)	(809.9)
Elimination of Investment Tax Credit	93.5	103.9	162.4	193.4	227.9	781.1
Change in Corporate Minimum Tax	37.3	83.9	35.0	40.0	32.9	229.1
Total Differences	182.3	265.5	329.9	401.2	472.8	1,651.7
Percentage Change	41.13%	61.64%	77.17%	92.98%	100.51%	74.96%

NOTE: Details do not add due to rounding.

Percentage Depletion. The Ways and Means bill will reduce the rate for percentage depletion allowances from 10 percent to 5 percent. This reduction accounts for 46 percent of the tax increase for the industry, totaling over $760 million over the next five years. By reducing the allowable percentage ratably over three years, the bill does alleviate the impact in the first year as compared to the later years of the projection period. The annual cost of this provision is projected to be three times as great in 1989 and 1990 as in 1986. The amount of depletion deductions claimed by the industry is projected to be $850 million in 1990, as compared to the $1.6 billion in deductions that would be allowed in that year under current law.

Mining Development Expenses. The Ways and Means bill calls for the recapture of mining development expenses when the mine is brought into production. The expenses can then be deducted as Class 1 property in the Incentive Depreciation System. During the projection period this proposal is expected to cost the coal industry $93 million, with the majority of the additional tax burden being realized during the second, third, and fourth years. After the first three years of recaptured expenses, this proposal essentially creates a timing difference with a smaller net effect, as evidenced by the projected cost of only $10 million in the last year.

Section 1231 Income. Royalty income earned by coal companies would no longer be taxed at preferred rates under the Ways and Means bill. The current preferred rate of 28 percent would be phased out over three years with rates of 30 percent, 31 percent and 32 percent. Section 1231 income would then be considered ordinary income in years beginning after January 1, 1989. The effect of this provision is to increase taxes over the five-year period by $37 million. During the first three transition years the effect is minimal, after which the projected increase in taxes due to this part of the bill is expected to be approximately $17 million annually.

There are five other parts of the Ways and Means bill that will have a significant impact on the amount of taxes paid by the coal industry over the next five years. These provisions are those that affect companies in general and are (1) the change in depreciation systems, (2) the decrease in corporate tax rates, (3) the elimination of the investment tax credit, (4) the change in the treatment of capital gain on depreciable assets, and (5) the change in minimum tax rules from the current "add-on" minimum tax to an alternative minimum tax. The aggregate effect of these five provisions is smaller than for the mining-specific provisions, amounting to approximately $750 million in tax increases over the period 1986 to 1990.

Depreciation. The Incentive Depreciation System (IDS) will allow reduced depreciation deductions for coal companies. The new allowances are projected to cost the industry $450 million during the period 1986 to 1990. Since most of the property used by coal companies will be depreciated over ten years under the IDS system as compared to five years under current law, the greatly reduced depreciation allowances have an effect in every year. This effect becomes more pronounced as more of a company's property is depreciated under the new system. By 1990, nearly all of the depreciation allowances of the coal industry will be computed according to IDS rules. Thus, the continuing effect of this proposal is likely to be closest to that projected for 1990.

Corporate Tax Rates. The Ways and Means bill calls for a cut in corporate tax rates from the current top rate of 46 percent to 36 percent. The effect of this proposal is to decrease taxes by over $800 million during the projection period.

The effect would be larger if the lower tax rate applied for all of 1986 rather than only half of the year. Of course, part of the magnitude of this decrease can be attributed to the broader base of income to which the lower rate is applied.

Investment Tax Credit. The investment tax credit would be repealed by the Ways and Means bill. Over the five-year period, coal companies would pay an additional $780 million in taxes due to the loss of the investment tax credits. The effect is largest in the later years of the projection period because more coal companies are projected to have positive taxable income by 1990. Thus, the carryover of investment tax credits will finally be used later in the projection period.

Change in Treatment of Capital Gain on Depreciable Assets. The Ways and Means bill would repeal special treatment for capital gains on depreciable assets, resulting in increased taxes of $117 million. Presently, when a depreciable asset is sold the excess of the sale price over the original cost is taxed at a preferential rate of 28 percent. In contrast with an earlier version of the Ways and Means bill, this provision applies to the sale of all properties after January 1, 1986. In the earlier version, the repeal of preferential treatment applied only to property placed in service after January 1, 1986. Thus, this provision will actually be applied retroactively to existing property.

Change in Corporate Minimum Tax. The current law "add-on" minimum tax would be repealed and replaced with an alternative minimum tax that would be similar in form to the present alternative minimum tax for individuals. This part of the bill will raise taxes by $230 million over the first five years of enactment. Two items of tax preference are the cause of this large tax increase, the excess of incentive depreciation over nonincentive depreciation and the excess of percentage depletion over the adjusted basis of the property. Since percentage depletion is retained, the excess depletion allowance accounts for a large share of the minimum tax paid. Also, note that the majority of the cost of this provision is in the first three years. This effect is the result of the interaction of investment tax credits, net operating losses, and the minimum tax. Since ITC's and preference-created NOL's cannot be used to offset the alternative minimum tax, few of the credits and losses will be used while coal companies are minimum taxpayers, with the effect of raising the cost attributable to this provision.

Dividends Paid Deduction. The last part of the Ways and Means bill that affects taxation of coal companies is the dividends paid deduction. The bill calls for the ten-year phase-in of a ten percent dividends paid deduction, beginning in 1987. This deduction is projected to save coal companies $8 million during the next five years.

Summary

The net effect of the Ways and Means bill on the coal industry is a dramatic increase in tax liabilities. Furthermore, it is significant that a large share of the increase in tax liability for the coal industry is a result of the changes in tax rules relating to the expensing of mining development costs and percentage depletion allowances, which apply only to extractive industries.

While transition rules are intended to smooth out the overall increase in tax liability, it is difficult to ameliorate the impact of what amounts to an average increase in tax liability of 75 percent over the 1986-1990 period. The increase in 1986 tax liability is projected to be 41 percent with steady increases from that point forward. Even though coal companies will feel the full impact of the Ways and Means bill only after five years, the increase in the first few years is so great that the transition from current law to the Ways and Means bill will have a significant impact on the short-run profitability of coal companies.

Senator NICKLES. Mr. Dahlgren, I appreciate your comments and I think you happen to be exactly correct on the problems that we're overspent, not undertaxed. I would like to ask our future panelists if the statements can be a little shorter; then I can ask a few more questions. But we do have two more panels, and I know some of you need to leave, as well.

But just a quick question: Both tax proposals that we've been reviewing are revenue neutral in the sense that they're supposed to raise as much money tomorrow as present law. They're not revenue neutral as pertaining to any industry that's made statements today, particularly natural resource industry. They're substantial increases for the natural resources industry. The coal industry right now receives, what at 10-percent depletion?

Mr. DAHLGREN. Yes.

Senator NICKLES. And under the proposal——

Mr. DAHLGREN. Under the President's proposal, that is cut out. In the Tax Reform Act, it's cut back, I believe——

Senator NICKLES. To 5 percent, I think.

Mr. DAHLGREN. Yes.

Senator NICKLES. And then also you have the situation I'm thinking as far as expensing. I know in the timber industry you're expensing a lot of things now that they would require to be capitalized; is that correct?

Mr. JENKINS. That's correct.

Senator NICKLES. I know in the oil and gas industry, that's the same thing where they're requiring capitalizing some portion of IDC's, et cetera, where you've had expensing of that in the past?

Mr. DAHLGREN. Yes.

Senator NICKLES. Now, Mr. Rodgers, you mentioned some concerns about not being able to expense your loan—bad debt loan reserves.

Mr. RODGERS. Right.

Senator NICKLES. You're required by law to establish a bad debt loan reserve of what?

Mr. RODGERS. You are given an option to either go the percentage method, which is six-tenths of 1 percent of your total loan portfolio, or taking your actual experience over the last 6 years and average, and say it was $100,000 a year or $1 million a year for the last 6 years, then you could have a bad debt reserve of $1 million.

What we were just saying is if you are forced to not have that and only have—be able to deduct loans you actually charge off, you're going to create a tremendous burden not only on the bank but the customers whose loans may not be chargeable off. In other words, you may not want to charge it off. And what we're saying is this is a rough time in banking in Oklahoma to start adding more expenses to banks.

Senator NICKLES. OK. One question on that. If I'm correct, and correct me if I'm wrong, I believe the House bill retains present law for any bank that's capitalized with assets of less than $500 million.

Mr. RODGERS. That is correct.

Senator NICKLES. That would take care of, what, most of the banks in Oklahoma with a couple—with, what, four exceptions?

Mr. RODGERS. Four or five exceptions. It also covers holding companies. That may add one or two more. The intent of my talk is to make sure that H.R. 3838, you know, doesn't drop back and pick up all banks. The President's proposal didn't pick up all banks. The H.R. 3838 said, "Well, we think that's OK for small banks, and not good for large banks." My argument is that undermines the whole intent of the present proposal, and that's fairness. If it's bad for a small bank, it's bad for a large bank. And since I represent the Oklahoma Bankers Association, I certainly can't stand up in front of you and say, "Well, that's fine for me in Blackwell, but, you know, let them have it in Oklahoma City." Our feeling is that it will be bad for everybody, and the final bill may come out against all banks.

Senator NICKLES. So you don't think that we should even have that exemption for any bank—we should basically allow the continued deduction of bad debt loan reserves?

Mr. RODGERS. Yes; because that adequately represents the banks' portfolio, that there are losses in it and we don't have to identify them specifically and force somebody into liquidation to get there.

Senator NICKLES. OK. Mr. Stephens, you had two examples, and I appreciate this—that's not done very often before our committees on tax policy, as I mentioned before.

You pulled out two examples of potential investments that just basically wouldn't be made, is that correct, if the legislation would go forward, at least two examples of legislation or proposals that might be marginal?

Mr. STEPHENS. That's correct. One of them was only a theoretical proposal to show the effect of the two tax reform proposals on the cash-flows which were just manufactured under the three different tax alternatives. The other one is an actual investment, the numbers are real, and the change in the tax law would prevent—to either of the two proposals as currently written would make that project uneconomic and, therefore, it couldn't go forward.

Senator NICKLES. And, Mr. Jenkins, you mentioned with Weyerhaeuser and the fact that you do business with a lot of small businesses, but you'd be in a similar situation of not, I guess, completing some of the investments that you now have invested as far as the timber industry is concerned, that you'd be in a liquidating process? In other words, not replenishing, not replacing, and, therefore, anyone who was associated with a satellite sawmill or whatever in the services industry could find themselves in bad shape, as well?

Mr. JENKINS. That's correct. We now buy chips and logs for, oh, approximately 30 percent of our volume, 20 or 30 percent of our volume. This law if passed as is would say, "Weyerhaeuser, you should liquidate your own assets and let these fellows do as they can. Because you've got to pass these on."

But I might say, too, "We've looked at the same type assets," and I can't say whether—exactly the impact, but it is similar to the impact on any industry, the same as Kerr-McGee has expressed.

Senator NICKLES. Let me just make one final observation. In McCurtain County in southeastern Oklahoma, isn't the timber industry as vital and dominant in southeastern Oklahoma as, say, the oil and gas industry might be in western Oklahoma?

Mr. JENKINS. I think so, yes, sir.

Senator NICKLES. I think so, as well.

Mr. Dahlgren, the coal industry has gone through some rough times of late with OSM and Oklahoma Department of Mines both. Some of us have been pushing—I know you've been working trying to get some Oklahoma coal burnt in Oklahoma utilities. I think some progress is being made there. But the number of producers that we have in the State has declined dramatically over the last several years so far as, I guess, independent coal producers in the State.

If either of these tax proposals are before us, do you see other producers going out of business?

Mr. DAHLGREN. To me it's just another squeeze on the small business people, like myself. If the return is not there and it's not large enough or the financial amount of money to get into business is so great, it's just going to squeeze that many more people out, and some of the people that are there.

Senator NICKLES. I appreciate your comments.

I'm going to have to go kind of quick, because we do have two more panelists, so all of our first panel, we thank you very much.

To our next panels, if you might summarize your comments a little bit.

Again I think I've read most of the statements that might move it a bit quicker.

First we have Jack Graves, Calumet Oil Co., representing the Oklahoma independent producers; we have James Thielke, tax partner of Peat, Marwick, Mitchell & Co., representing the Oklahoma Society of CPA's; Mr. Ken Culver with the Dozier Group in Oklahoma City; and Gene Imke.

Mr. Graves, do you care to be first?

STATEMENT OF JACK GRAVES, CALUMET OIL CO., TULSA, OK; REPRESENTING THE OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

Mr. GRAVES. Thank you, Senator Nickles, and good afternoon to you, and good afternoon, ladies and gentlemen.

I'm Jack Graves, president of OIPA, the Oklahoma Independent Petroleum Association, founded in 1955 and headquartered in Tulsa, representing the interests of 1,500 Oklahoma oil and gas independent producers.

I also appear before you today as a small businessman. I've been involved in oil and gas exploration and production in Oklahoma for 40 years; 29 years as an independent. I own and operate four production and petroleum-related service companies in northeastern Oklahoma, and we employ around 110 people.

OIPA and I appreciate this opportunity, Senator Nickles, to appear before you as we have done many times in the last 14 months, to discuss and sound a warning about the potentially devastating effect of the proposed tax reform and what effect it will have on the independent producers who for the most part are small businessmen.

Senator Nickles, OIPA does not take issue with the overall intent to revise the U.S. Tax Code in order to achieve simplification. But what has been—what has come out of Washington so far is anything but simplification. It's our position that the independent petroleum industry should and does pay its fair share of taxes; however, when we compare this with the so-called revenue neutrality that is proposed, we are reminiscent of the fact that before anything can be neutral, it has to be taken out of gear and these proposals will certainly take the oil and gas industry in Oklahoma out of gear. Both Treasury II and Rostenkowski I will harm, possibly irreparably, an industry that is so vital to the Nation's welfare in terms of jobs, tax revenue, energy sufficiency, and national security.

I've said it many times before, and I'll repeat it today, that capital flees uncertainty. The petroleum industry today is ravaged by uncertainty, and much of it is the uncertainty of how any well that we might drill or any property that we might buy will be treated by Congress and by the Internal Revenue Service under tax reform. We know, of course, that outside investment aids the oil and gas industry to a great extent. But when we start deleting such things as the current tax treatment, the deduction for intangible drilling cost, the deduction for percentage depletion allowance, while some may call these special provisions, we know in fact that these particular aspects have been in the tax law for something—well, maybe for as long as 70 years, some of them. The Government has acknowledged these aspects and the wisdom in keeping them there in an effort to make the tax system fair and uniform to all. The special provisions did not just hop in there overnight. They were put in there after a lot of long study and concern for the natural resource base of the country.

Senator, we keep hearing about software over and over again in Washington. We'd like to state that the country cannot exist on software alone. We cannot prosper even on a software economy. It's elementary that we have a positive balance of trade, and we need to sell more overseas than we buy. And this is one message that we would like for you to take back to Washington, that this probably is more important than the—well, the hydra-headed snake that comes out as tax reform.

We think that hard goods can be manufactured competitively here. Our resources can be extracted profitably if we have a little help from the Government, if in fact that we have maybe at least some of the subsidies that the foreign producers get. We hear so much about the level playing field, but our opinion and our observation is that if there is a playing field out there that's supposed to be level, it in fact does tilt toward the foreign producers of goods instead of tilting in our favor.

Repealing or dramatically altering these provisions, the IDC's, intangible drilling costs, percentage depletion, alternative minimum tax, depreciation and investment tax credit without question will change the economics of drilling and producing and negatively impact both the independent producer and investor psychology.

Now, the reduction in the marginal tax rates contained in Treasury II and Rostenkowski I will not be sufficient to offset the truly negative impact of the loss of the current deductibility of the intangibles and depletions in the minds and the bank accounts, I might add, of the independent producers and investors. We would be better served by a stable tax system which would permit long-term business decisions rather than a sweeping reform that would change the entire playing field.

By its very nature, uncertainty from either of these proposals, Treasury II or House bill 3838, will cause instabilities in the foreseeable future due to the inevitable changes that would result. The independents have a premonition that uncertainty today will be factual disaster tomorrow.

Price instability in the foreign production or, if you will, the manipulation of the United States by OPEC, the economic uncertainty and the unwillingness of lenders to take new petroleum risks have combined to create a deep and continuing recession in all sectors of the oil and gas industry. This recession has put great financial pressure on many producers who do not have the resources to deal with additional negative factors. In other words, they face bankruptcy.

It's now been 14 months, Senator, since the oil and gas industry was unexpectedly confronted with the Treasury Department's lack of concern over the plight of American manufacturing and extractive industries, and small business in general. Small business, of course, as you know, is probably the country's biggest employer. The Washington buzz words that we've heard again so many times, free world market and level playing field, seem to overlook the fact that the U.S. exporters encounter over 227 barriers to free and unrestricted trade. The pervasive attitude that we see from Washington is, "As long as we can buy eggs at the supermarket, who needs chickens?" Well, we'd like to state today that we all need our chickens.

We realize this isn't a discussion of the administration's free trade policy, but I am compelled to make the point that the domestic petroleum industry, as you know, especially with independents, it's impossible if at least most difficult to compete with imported crude oil that's subsidized wholly or in part by an exporting government.

Intersecting all of this so that we have the problems we have, the upwardly spiraling costs, we now have come to a time of downward spiraling prices for wellhead prices of oil and gas.

Over 1 year ago when Treasury I was introduced, the independent industry in unison predicted the danger that we now all will face from potentially higher taxes, and this does threaten the existence and continuation of thousands of small businesses.

Senator Nickles, as I prepared this testimony, the spot price for North Sea oil fell below $16 a barrel. I don't know what it is today. But the independents have been barely existing and now we are going to experience another turn of the screw, increased taxation as a result of so-called tax reform.

Oklahoma crude is fluctuating around $20 a barrel, down from $27 a barrel not too many weeks ago. But at $20 a barrel, that is not net to us. As you know, at least one-fourth of that comes off as royalty and gross production tax. So, we earn $15 a barrel, and that is awfully close to the lifting cost for a barrel of Oklahoma crude. So to suffer or endure a further decrease in moneys because of Treasury proposals will be disastrous for the State.

Just very briefly, we took one producer's tax return to compare what Treasury II and Rostenkowski I would do. This producer reinvested 117 percent of his net taxable income back into exploration and development in 1984, and I might add that this is more or less an average for the industry. It seems that independents as a group plow back somewhere around 107 to 108 percent of their taxable income that they take out of the ground. I don't know any other industry that has that kind of record or commitment toward their own business.

Treasury II would be the lesser of the evils. The dominant factor in Treasury II that would increase the taxes for this particular independent was the loss of investment tax credit, which in his case would have increased his taxes by 15.8 percent. The other factors were not as meaningful, but they did total up to a total loss for Treasury II would have been an increase in Federal taxes of 21.4 percent.

Now, this is for an independent that plowed back 117 percent of what he took out of the ground.

This, however, pales in comparison to the harm of Rostenkowski I. Under that plan the same producer found that he would have a 43.4-percent increase in taxable income over 1984 actual taxes. There again—the alternative minimum tax was 16.3 percent compared there with, of course, the other on Treasury II, the big item was the investment tax credit. This, of course—investment tax credit—also plays a part in this increase, the same 15.8 percent.

The shuffling around of percentage depletion allowances, the alternative minimum tax, the preference items all would make this taxpayer's taxes increase 43.4 percent. It does not seem that this is anywhere near fair and equitable for—and this is not fair for the independent industry, for persons who would plow back 117 percent of taxable income, then to be faced with an increase that may be as much as 43 percent. The alternative minimum tax, I might add, is a wolf in sheep's clothing that they are taxing the preference items that one must pay taxes on. It does not seem right that one should be taxed for lawfully taking deductions that were authorized under the tax law to start with.

In the interest of saving time, Senator, I will curtail the remarks. The Oklahoma independent petroleum industry continues to call loudly for the preservation of current tax law for the petroleum industry. The industry that already pays 14 percent more in taxes than other industry needs present law. We thank you for this opportunity to express our views and for your sincere interest in the economic welfare of Oklahoma. Thank you.

[The prepared statement of Mr. Graves follows:]

PREPARED STATEMENT OF JACK GRAVES, CALUMET OIL CO., TULSA, OK; REPRESENTING THE OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

Good afternoon, Senator Nickles...

I am Jack Graves, President of OIPA, the Oklahoma Independent Petroleum Association. OIPA, founded in 1955 and headquartered in Tulsa, represents the interests of 1,500 independent oil and gas producers with operations in Oklahoma. I also appear before you today as a producer and small businessman. I have been involved in oil and gas exploration and production for 40 years; 29 years as an independent in Oklahoma. I own and operate four production and petroleum-related service companies in northeastern Oklahoma which employ 110 people.

OIPA and I appreciate the opportunity to appear before you Senator Nickles, as we have many times during the past 14 months, to discuss and sound a warning about the potentially devastating effects proposed federal tax reform will have on independent oil and gas producers who, for the most part, are small businessmen. Per the specific purpose of today's hearing, we will concentrate our comments on the two reform proposals now before the Congress-- President Reagan's proposal, which we commonly refer to as Treasury II, and House Bill 3838, which we in the petroleum industry have come to call Rostenkowski I.

Senator Nickles, OIPA does not take issue with the overall intent to revise the U.S. Tax Code in order to simplify the highly complex process of accounting, filing and paying taxes and to lower, where possible, the tax burden on individuals and corporations. Further, it is OIPA's position the independent petroleum industry should and does pay its fair share of taxes to contribute to a quality of life for which America has become known. However, when measured against the stated reasons and goals for comprehensive tax reform, the reforms being considered today-- Treasury II and Rostenkowski I-- obviously fail to achieve simplicity and, more importantly, will fail to contribute to the nation's fiscal condition. To the contrary, both Treasury II and Rostenkowski ultimately will harm, possibly irreparably, an industry vital to the nation's welfare in terms of jobs, tax revenue, energy sufficiency and security.

Drilling activity in the U.S. is governed mainly by the availability of economically attractive prospects and access to the capital required to develop those prospects. Since many oil companies typically invest all their cash flow, oil field activity frequently is estimated on the basis of expected changes in cash flow. Unfortunately, history shows proportional changes only when there are comparatively minor changes in oil field economics.

For example, during the latest boom-to-bust cycle, the change in drilling expenditures increased and decreased, respectively, in amounts greater than accounted for by changes in cash flow. Spending by outside investors in 1982 surged to $11.7 billion, declining thereafter to $1.5 billion in 1984. Spending by outside investors shows greater sensitivty to expected profitability than to industry cash flow. This again was demonstrated in 1985, according to a study recently published by Resource Programs Inc., a New York investment advisory company. According to RPI, there were fewer companies out raising money last year, and the amount raised decreased 54 percent, to $675 million.

The RPI survey says money raised for exploratory and development drilling programs was down 18 percent, while money raised to purchase already producing properties fell an overwhelming 75 percent.

I have said it before, and I repeat it today: capital flees uncertainty. The petroleum industry is ravaged by uncertainty, and much of it is the uncertainty of how any well we might drill or property we might purchase will be treated by Congress and the Internal Revenue Service under tax reform. It is inarguable outside investment is attrcted by the potential benefit, some of which is provided by the industry's current tax treatment, such as the allowed deduction for Intangible Drilling Costs (IDCs) and the allowed deduction of the Percentage Depletion Allowance. While some of our enemies and the uninformed call them, quote, special provisions, unquote, they, in actuality, are provisions which address unique aspects of the oil and gas industry. The Federal Government has acknowledged these aspects for more than 70 years by enacting, maintaining and preserving these provisions in one for or another.

We keep hearing the term software over and over again from Washington. The country cannot exist let alone prosper on a software economy. It is elementary that in order to have a positive balance of trade we need to sell more overseas than we buy. Certainly software alone will not do it. Consequently, the solution seems to demand hard goods can best be competitive if manufactured economically in modern plants and factories which are possible through Investment Tax Credits (ITCs), for example.

Not only do ITCs encourage the independent to invest in needed equipment, they are vital to the continual updating and modernizing of domestic refineries, without which we will become more dependent on imported petroleum products and lack adequate refining capacity in this country, causing thousands of barrels per day of oil production to be shut-in and be displaced by imported crude.

Repealing or dramatically altering these provisions-- IDCs, Percentage Depletion and ITCs-- without question, will change the economics of drilling and negatively impact investor psychology. We saw an example of that in 1981 when the marginal tax rate was reduced from a maximum of 70 percent to 50 percent, certainly a reduction welcomed by all. However, the drop in the tax rate discouraged investment by individuals who were willing to share some of the inordinately high risk unique to the petroleum industry. The recent drop in spending by both independents and outside investors unquestionably came about, to a large degree, because a reduction of the tax rate lessened the need for investment in tax efficient programs.

Now, the reduction in the marginal tax rates contained in Treasury II and Rostenkowski I will not be sufficient to offset the truly negative impact of the loss of current deductibility of intangibles and depletion in the minds of investors. We would be better served by a stable tax system which would permit long-range business decisions than by sweeping reform which would change the entire, quote, playing field, unquote. By its very nature, such a fundamental reform-- either one of the two proposals-- would preclude stability in the forseeable future due to the inevitable changes that would result.

Price instability, excess foreign production, or, if you will, the manipulation of the United States by OPEC, investor uncertainty and the unwillingness of lenders to take new petroleum risks have combined to create a deep and continuing recession in all sectors of the oil and gas industry. This recession puts great financial pressure on many producers who may not have resources to deal with additional negative factors. In other words, they face bankruptcy.

It has been 14 months since the oil and gas industry was unexpectedly confronted with the Treasury Department's lack of concern over the plight of American manufacturing and extractive industries and small business in general. The Washington buzz words and phrases became "free world market" and "level playing field", without regard for the fact U.S. exporters encounter more than 227 barriers to free and unrestricted trade. The pervasive attitude, expressed by more than one Administration official, is: so long as we can buy eggs at the supermarket, who needs chickens.

I realize the purpose of this hearing is not a discussion of the Administration's free trade policy. But I am compelled to make the point that for the domestic petroleum industry, especially the independents, it is difficult, if not impossible, to compete with imported crude oil subsidized wholly or in part by an exporting government. In fact, the playing field does tilt to the favor of foreign producers of oil and gas.

Lifting costs for domestic oil and gas are extremely high because of a number of wounds inflicted by our own fiscal and tax policies. For example the cost and consequences to the producer of insurance have resulted in unrealistic settlements and premiums, and, in many cases, the inability even to acquire certain types of coverage. The burden of regulatory compliance is another wound which often costs as much in time and personnel as searching for and producing oil and gas. Included is the myriad of federal and state agency and municipal requirements which, although partially necessary, have become intrusive, oppressive and redundant.

Intersecting these upwardly spiraling costs is the downward spiral of wellhead prices for oil and gas.

Over a year ago when Treasury I was introduced, the independent domestic industry, in unison, predicted the danger we now face from the combined effect of drastically lower prices and potentially higher taxes which threaten the very existence and continuation of independent producers, or, in other words-- and to bring my comments back to the main point-- the very existence and continuation of thousands of small businesses.

Senator Nickles, as I prepared this testimony, the spot price of North Sea crude fell below $16.00 a barrel. Until now, independent producers have been barely existing, but obviously we are to experience another turn of the screw-- increased taxation as a result of so-called tax reform.

Today, the price for domestic crude in Oklahoma is fluctuating around $21.00 a barrel. The general public and many lawmakers look at the price and their reaction is: So what? You were getting $30 a barrel; now you're getting $21. At least you're still getting that.

But the producer is not getting $21. As much as 18.75 percent of that money goes to royalty owners. Then the operator must pay more than seven percent in severance taxes in Oklahoma on his working interest, which could be all the working interest. Thus, more than 25 percent of that $21 per barrel-- $5.25-- is lost even before lifting costs are paid, banks are paid, overhead is paid and federal and other state taxes are paid.

Senator, let's closely examine the condition of the petroleum industry in our State. The dismal information I am about to share is the result of those factors I mentioned: lower prices, surpluses of supply, OPEC and the uncertainty created by tax reform debate. Enactment of either Treasury II or Rostenkowski I will make it worse.

Oklahoma oil and gas producers drilled 25 percent fewer wells in 1985 compared with 1982; we drilled almost 10 percent fewer wells last year than in 1984.

The rig count in Oklahoma fell from an annual average of 622 in 1982, down to 319 in 1984, and further down to 250 last year. Experts estimate for every oil rig and every gas rig which do not operate for a year in Oklahoma costs 273 jobs, $11.8 million in gross wages and $600,000 in state tax revenue, excluding severance taxes.

In 1982, there were 102,100 persons employed in Oklahoma's oil and gas extractive industries. Today, that number is less than 65,000. Meanwhile, statewide unemployment during the same period rose from 85,000 to 112,000 persons. There also are tens of thousands of persons who are employed, but are limited or restricted to less than full employment (40 hours per week) because of the declining level of oil and gas activity.

And, in northeastern Oklahoma alone, bankruptcies increased 22.5 percent in 1985, to a record 2,453. The rise in bankruptcies, according to experts, is, quote, an echo of the oil bust that sheared off the state economy, unquote. The current pricing situation in the petroleum industry and the proposed tax reform schemes are like a double-barrelled shotgun aimed right our heads. OPEC has its finger on one trigger and, in my opinion, has, as I and others predicted 14 months ago, fired its shot which is devastating the domestic market.

Congress and the President have their collective finger on the trigger of the other barrel.

The situation is critical. We know the U.S. will need to find 13 million barrels per day of new crude oil production between now and 1994 if we are to simply maintain our current level of dependency on foreign imports without requiring more. How can we as an industry be expected to accomplish this with the price for North Sea crude, on the spot market, below $16 per barrel as of Tuesday, and the spot market price for West Texas Intermediate below $17 per barrel? How can we just stay even if the effects of Treasury II, if enacted, would be equivalent to a $2 to $3 per barrel decline and a production decline of 130,000 barrels per day?

To cite more specific examples of the effects of Treasury II and Rostenkowski I, one producer, who reinvested 117 percent of his net taxable income back into exploration and development in 1984, computed his financials and tax returns for that same year based on each proposal. The figures not only prove tax reform, as proposed, is bad for the petroleum industry, for Oklahoma and for the nation. They also raise the question of whether we want to drink a full or half glass of poison.

In comparing present law with Treasury II and Rostenkowski I, we find negative and damaging effects on small businesses-- independent oil and gas businesses-- from both proposals. Under Treasury II, the Oklahoma independent producer, who provided us the figures, would have seen the following results in 1984:

-- Loss of Investment Tax Credit (ITC) would have increased taxes 15.8 percent, an amount which corresponds to 4.3 percent of the producer's 1984 drilling budget.

-- The Alternative Minimum Tax computed on eight percent productive IDCs would have cost another 3.3 percent increase in taxes and reduced the drilling budget nine-tenths of one percent.

-- The prodcuer's lost percentage depletion on non-stripper well properties calculated to another tax increase of six-tenths of one percent; two-tenths of one percent of the drilling budget.

-- Losses of depreciation deductions during the first year, if applicable in 1984, would have cost the producer another 1.7 percent in additional taxes, and decreased the drilling budget another four-tenths of one percent.

-- The total loss under Treasury II: an increase in federal taxes of 21.4 percent, which also would have meant a 5.8 percent decrease in the drilling budget.

While Treasury II is not acceptable, it pales in comparison to the harm of Rostenkowski I. Under that plan, the same producer found:

-- Loss of ITC would have increased taxes the same 15.8 percent.

-- Increasing the Alternative Minimum Tax from 20 percent to 25 percent would have spiked taxes another 16.3 percent.

-- Loss of the Percentage Depletion Allowance would have cost another 1.2 percent, which is twice as much as under Treasury II.

-- Current Year IDCs to be deducted in future years would have forced the producer's taxes up another 7.8 percent in 1984; the loss of first year depreciation deductions would have tacked on another 2.3 percent.

-- The total cost to this producer under Rostenkowski I would have been a 43.4 percent increase in federal taxes over actual 1984 taxes paid under current law. That increase represents 11.7 percent of his drilling budget for the same year.

That, Senator Nickles, is what Treasury II and Rostenkowski I will do to the independent producer; to the small businessman who has chosen petroleum as his way of making a living. This does not take into account the millions of barrels of production we will lose; the hundreds of rigs which will be stacked; the greater dependency on foreign imports; the bankruptcies; the unemployed.

It seems painfully obvious the belief the petroleum industry no longer needs unique or differential tax treatment is held by people handicapped by a feeble memory further worsened by myopia. They have forgotten the early 1970s when the U.S. was placed at the mercy of OPEC (and they seem not to recognize we, today, are in the same situation); they have forgotten the late 1970s when schools and factories were closed because not enough natural gas could be delivered for heat and fuel; and they have forgotten history which documents the cyclical nature of the petroleum industry-- shortage, surplus, shortage. We have been through the shortages of oil and gas, now there are surpluses. Not to see or expect shortages in the future, especially with the burden of Treasury II or Rostenkowski I, is to ignore history and beg for trouble.

Both Treasury II and Rostenkowski I exact far too high a price and will be devastatingly oppressive for the industry, especially in this new era of $20-- and less-- per barrel. The industry cannot withstand sustained low crude prices, lost incentives, lost outside investment capital and increased taxes.

And, Senator Nickles, there is one other thing independent producers and all other small businessmen cannot live without-- the 100 percent deduction of corporate interest payments. To us, it is inconceivable the idea of limiting interest deductions for corporations would even be proposed, much less given serious consideration. But it has been proposed and the staff of the Senate Finance Committee is studying it. You are a businessman, Senator. You can see the certain devastation such a limitation would cause. We state an emphatic no to any limit on interest deductions.

The Oklahoma Independent Petroleum Association continues to call loudly for the preservation of current tax law for the petroleum industry. The industry which already pays 14 percent more in taxes than others need it.

Thank you for this opportunity to express our views and for your sincere interest in the economic welfare of Oklahoma.

Senator NICKLES. Mr. Graves, thank you very much. Mr. Culver.

STATEMENT OF KEN CULVER, THE DOZIER CO., OKLAHOMA CITY, OK

Mr. CULVER. Thank you. My name is Ken Culver; I'm a partner in the Dozier Co. The Dozier Co. is a private actuarial/administration company which services approximately 350 retirement plans. The large majority of our plans have less than 100 participants. My personal experience in this area spans over 18 years. I wish to compliment Senator Nickles for his interest in retirement plans and for the unusual step of holding hearings in Oklahoma and allowing us to give input into this very important area.

Although my concerns for the retirement provisions of H.R. 3838 and the President's tax proposal are numerous, my remarks will be confined to four of which I consider the most important.

Senator, should you or your staff require additional input on any other items, we would certainly be willing to provide such.

Senator NICKLES. Thank you.

Mr. CULVER. The annual savings rate in the United States is among the lowest of any Western democracy. This is not a new revelation although it is become more startling on a day-to-day basis. As a result of our declining savings rate, a progressively higher percent of our low level of savings is coming from qualified retirement plans. Therefore, qualified retirement plans are being asked to carry a larger and larger load of capital formation which is important for the growth and well being of our Nation.

The first item which I would like to discuss is the repeal of section 415 of the Internal Revenue Code. When ERISA was passed in 1974, it established the 415 limits as $25,000 for defined contribution plans and $75,000 for defined benefit plans. In order to protect the integrity of these amounts, Congress wisely indexed them to reflect inflation by providing a COLA, cost-of-living allowance. As you'll note on the submitted testimony, this has changed on a year-by-year basis, starting with $75,000 for defined benefit plans in 1975 which had increased to $136,425 by 1982. For defined contribution plans, this was $25,000 in 1975 which had increased to $45,475 by 1982. When TEFRA was passed in 1982 without public testimony, 415 limits were reduced to $30,000 for defined contribution plans and $90,000 for defined benefit plans—approximately a 34-percent decrease—with a delayed COLA.

Although this was not good retirement policy, it was accepted if not rationalized by many that our country had a revenue problem and that all segments must sacrifice. Now, specifically, H.R. 3838 would further reduce the 415 limits to $25,000 for defined contribution plans and $77,000 for defined benefit plans.

This would place us back where we started 10 years ago and completely ignore the integrity of ERISA as it related to inflation. Perhaps the House and the President did not understand the effect of a reduction in the 415 limits, or even more startling is possibly they do not believe that the highly paid, such as the owners and the officers, are the only ones affected. Surely they do not believe it is possible that reduction in contributions will create more investment capital.

A factual situation is an employer who has a pension plan with a contribution rate of 10 percent of payroll. He also has a profit-sharing plan with an optional contribution of 15 percent of payroll. Due to the past cutback and the proposed cutbacks, this employer has discovered that it is now possible only to maintain the 10-percent plan—considering the amount of money which he would like to contribute for his behalf—and discontinuing the 15-percent plan. This situation currently exists. The result is less investment for capital formation and reduction in benefits for the rank and file employees.

H.R. 3838 is to be applauded for recognizing the defined benefit plans provide better retirement security than defined contribution plans.

As a result of this, they are suggesting that the 415 limits for the defined contribution be frozen until there is a 4-to-1 ratio rather than a 3-to-1 ratio. However, the desired solution is to increase the current $90,000 to $120,000 rather than start at $25,000 to $77,000 and wait for the $77,000 to increase.

Also the H.R. 3838 comments on the 10-year service versus the 10-year participation were weak and completely disregarded situations where the owner and/or his family are the only participants.

Finally, due in some respects to current tax policy and the spending pattern of Congress, many individuals have found it necessary to work two full-time jobs. It is not right that the entrepreneurship of these individuals be penalized by having their benefits penalized if it exceeds a certain amount.

The second item, a topic that has been on the front burner for several years, concerns 410(k) plans. The elective deferral on behalf of any employee is currently the lesser of $30,000 or 25 percent of compensation. H.R. 3838 would substitute a $7,000 limit on elective deferrals while reducing the total dollar limit from all sources to $25,000.

This appears to be a bias directed against the successful small business owner who might be able to personally contribute more than $7,000 a year. They're not restricting the amount of money that may go to a person's account; they're only restricting the amount that the individual may contribute.

Perhaps even harder to understand is the bill's reduction in the individual IRA amount by $1 for each $1 the individual elects to contribute to a 401(k) plan up to the current maximum of $2,000 on an IRA.

In a small business, and I'll describe this as perhaps one with under 100 employees, the benefits to the people who are responsible for the success of the business are very closely scrutinized before the adoption of a retirement plan. Since all employees became eligible for an IRA in 1981, many of the people who were responsible for the success of a business already have an IRA. Consequently, with proposed legislation, it may not be beneficial to establish a 401(k) plan containing the IRA offset provision. If the 401(k) plan is not established, the results are less money available for retirement and less money available for capital formation. Recognizing the Treasury Department completely miscalculated the popularity of 401(k) plans, it is nevertheless felt that capital formation and employee retirement security should not be sacrificed by ill-conceived ,rules which will retard the growth of 401(k) plans. Due to the loss in revenue, it is hesitantly acknowledged that the $30,000 figure for elective deferrals must be reduced. However, it is suggested that individuals not be so severely penalized as a $7,000 limit would do. It is further suggested that a limit in the $12,000 to $15,000 range be considered.

Finally, one of the cruelest aspects of H.R. 3838 as it pertains to 401(k) plans is the 15-percent penalty tax on distributions before age 59½. This is particularly pungent to a hardship withdrawal.

Let's consider this situation: An individual qualifies for hardship withdrawal due to unexpected emergencies for which no other funds exist. The individual receives the money from the plan administrator through established procedures, and let's use an example of $20,000. The $20,000 reflects the exact amount of money required for the hardship. First the individual has to pay income tax on the $20,000, thereby creating an additional hardship. Can you imagine the shock when the individual learns that an additional 15-percent penalty tax will also be due? This would be similar to offering a thirsty person vinegar. While our tax policy certainly does not meet the objectives of every citizen, it certainly should not be vindictive.

Integrating a retirement plan, particularly a defined benefit plan with Social Security, has been a misunderstood concept since the advent of Revenue Rule 71-446. First of all it's amazing how many employees are not aware that their employer has to make a matching contribution to the Social Security fund that matches their contribution.

H.R. 3838 proposes to limit the amount of Social Security benefits that an employee can use in benefit calculations via a fraction with the numerator being the number of years of service for that employer and the denominator being 40 years. In a certain type of plan called an offset plan, there is some merit to that idea, because an offset pension plan decreases the amount of the benefit through the use of Social Security. But in all other types of retirement plans, this idea does not have any merit since the integration part only enhances the benefit of some individuals.

Finally, the percentage test for plan coverage. A plan can meet the percentage test if it benefits at least 70 percent of all employees, or if at least 70 percent of all employees are eligible to participate and the plan benefits 80 percent of those eligible to participate.

An alternate method is called the "fair cross section test." The IRS can determine that a plan covers a classification of employees that is found not to discriminate in favor of the prohibited group. Thus we have objective and subjective tests which have worked quite well for a number of years.

Our question is, "Where is the discrimination?" I would be very reluctant to revert to any test that has no flexibility such as one initially considered by H.R. 3838. Furthermore, I commend H.R. 3838 for recognizing that changing the existing guidelines might be counterproductive in addition to confusing. However, I question their action requiring that the Department of the Treasury conduct a study on the perceived problem. This would be similar to asking the wolf to guard the chicken coop.

When looking at H.R. 3838 as a total package, I view the results as: No. 1, it slows the growth of investment capital; No. 2, it cuts back and/or freezes the benefits to the rank and file employees; No. 3, plans will become more expensive to administer for employers; and No. 4, it adds confusion to both employers and plan participants.

Senator Nickles, thank you again for the opportunity to present these views. I trust you will find them helpful.

[The prepared statement of Mr. Culver follows:]

TESTIMONY OF
PROPOSED PENSION LEGISLATION
FEBRUARY 10, 1986

My name is Ken Culver. I am a partner in The Dozier Company. The Dozier Company is a private actuarial/administration company which services approximately 350 retirement plans. The large majority of our plans have less than 100 participants. My personal experience in the retirement plan community spans eighteen years. My professional affiliation is with the American Society of Pension Actuaries (ASPA). The designation, Certified Pension Consultant, was earned through the passing of APSA monitored exams concerning pension law. I was born in Oklahoma and have lived in Oklahoma City since 1975. I wish to complement Senator Nichols for his interest in retirement plans and for the unusual step of holding hearings in Oklahoma and allowing us to give input in this very important area.

Although my concerns of HR3838 and the President's Tax Proposal are numerous, my remarks will be confined to four of the most important. Should Senator Nichols or his staff require additional input on these four areas or any of the other provisions of HR3838, please let me know.

The savings rate of the United States is among the lowest of any western democracy. This is not a new revelation although it is becoming more startling. As a result of the declining savings rate, a progressively higher percent of our low level of savings is coming from qualified retirement plans; therefore, qualified retirement plans are being asked to carry a larger and larger load of capital formation which is important for the growth and well being of our nation.

1. Repeal of 415 limits

When ERISA was passed in 1974, it established the 415 limits as $25,000 for defined contribution plans and $75,000 for defined benefit plans. In order to protect the integrity of these amounts, Congress wisely indexed them to reflect inflation (COLA). Following are the changes that occured from 1975 through 1982:

Year	Defined Benefit Dollar Limit	Defined Contribution Dollar Limit
1975	$ 75,000	$ 25,000
1976	80,475	26,825
1977	84,525	28,175
1978	90,150	30,050
1979	98,100	32,700
1980	110,625	36,825
1981	124,500	41,500
1982	136,425	45,475

When TEFRA was passed without public testimony in 1982, the 415 limits were reduced to $30,000 for defined contribution plans and $90,000 for defined benefit plans (a 34% decrease) with a delayed COLA. Although this was not good retirement policy, it was accepted/rationalized by many that our country had a revenue problem and that all segments must sacrafice.

Now HR3838 wishes to further reduce the 415 limits to $25,000 for defined contribution plans and $77,000 for defined benefit plans. This would place us back where we started 10 years ago and completely ignore the integrity of ERISA as it related to inflation. Perhaps the House and President do not understand the effect of a reduction in the 415 limits. Is it possible that they believe the highly paid, such as owners and officers, are the only ones affected? Is it possible that they believe that a reduction in contributions will create more investment capital?

A factual situation is an employer who has a pension plan with a contribution rate of 10% of payroll. In addition the employer has a profit sharing plan which allows an optional contribution of 15% of payroll. The employer discovered (due to the previous reduction in the 415 limits) that only the profit sharing plan is required for the employer to receive the maximum dollar amount; therefore, he has discontinued the pension plan. The result of the above is that the rank and file employees will be receiving a lesser benefit in the future and there will also be less investment capital in the future. This situation currently exists and will be greatly aggrevated by the further reductions in HR3838. Additionally, the counting of all employee contributions under 6% against the 415 limits in effect tells the employee to stop these contributions; thereby, another example of less dollars to assist in capital formation.

HR3838 is to be applauded for recognizing that defined benefit plans provide better retirement security than defined contribution plans. As a result, the ratio should be more than the current 3:1. The desired solution is to increase the current $90,000 to $120,000 rather than start at $25,000/77,000 and wait for the $77,000 to increase.

The HR3838 comments on the 10 year service versus 10 year participation were weak and completely disregarded situations where the owner and/or his family are the only participants.

Finally, due in some respects to current tax policy and the spending pattern of Congress, many individuals have found it necessary to work at two full time jobs. It is not right that the entrepreneurship of these individuals be penalized by having their benefit penalized if it exceeds a certain amount.

2. 401(K) plans

The elective deferral on behalf of any employee is currently the lesser of $30,000 or 25% of compensation. HR3838 would substitute a $7,000 limit on elective deferrals while reducing the total dollar limit from all sources to $25,000. It appears that HR3838 is not concerned that an employee could have $25,000 allocated to his account in one year. Rather, it inhibits the employee that can afford to contribute an amount which exceeds $7,000. This appears to be a bias directed against the successful small business owner who might be able to personally contribute more than

$7,000 per year.

Perhaps even harder to understand is the bill's reduction in the individual IRA amount by $1 for each dollar the individual elects to contribute to a 401(K) plan. In a small business (under 100 employees) the benefits to the people who are responsible for the success of the business are very closely scrutinized before the adoption of a retirement plan. Since all employees became eligible for an IRA in 1981, many of the people who are responsible for the success of the business already have an IRA. Consequently, with the proposed legislation, it may not be beneficial to establish a 401(K) plan containing the IRA offset provision. If a 401(K) plan is not established, the results are less money available for retirement and less money available for capital formation. Recognizing that Treasury Department completely miscalculated the popularity of 401(K) plans, it is nevertheless felt that capital formation and employee retirement security should not be sacrificed by ill-conceived rules which will retard the growth of 401(K) plans. Due to the loss in revenue, it is hesitantly acknowledged that the $30,000 figure for elective deferrals must be reduced; however, it is suggested that individuals not be so severely penalized as the $7,000 would do. It is further suggested that a limit in the $12,000/15,000 range be considered.

Finally, one of the cruellest aspects of HR3838 as it pertains to 401(K) plans is the 15% penalty tax on distributions before age 59 1/2. This is particularly pungent to a hardship withdrawl. Let's consider this situation:

1) Individual qualifies for hardship withdrawl due to an unexpected emergency for which no other funds exist;
2) Individual receives monies from plan through hardship procedures established by the Plan Administrator in the amount of $20,000. The $20,000 reflects the exact amount required for the hardship;
3) Next, the individual has to pay income tax on the $20,000 thereby creating an additional hardship;
4) Can you imagine the shock when the individual learns that an additional 15% penalty tax will also be due? This would be similar to offering a thirsty person vinegar. While our tax policy certainly does not meet the objectives of every citizen, it certainly should not be vidictive.

3. Social Security

Integrating a retirement plan, particularly a defined benefit plan, with Social Security has been a misunderstood concept since the issuance of Revenue Ruling 71-446 and its various updates.

First, it is amazing that many employees are not aware that the employer must match their Social Security withholding amount until a certain amount of salary is received from one employer per calendar year ($42,000 in 1986).

There are basically two methods of integrating a defined benefit plan:

1) Step rate -- an example is "a benefit of 50% of all compensation plus a benefit of 30% of all compensation above a dollar figure." The dollar figure is provided as a result of Revenue Ruling 71-446.
2) Offset -- an example is "a benefit of 50% of all compensation less 74% of Social Security amount received at retirement."

HR3838 proposes to limit the amount of Social Security benefit that an employer can use in benefit calculations via a fraction with the numerator being number of years of service with that employer and the denominator being 40 years. There is some merit to the idea as it relates to offset plans due to:

1) The amount of the Social Security is used to reduce the amount of benefit the employer must eventually provide.
2) There are no years of service required by Revenue Ruling 71-446 in order to receive the full benefit in an offset plan.
3) If Social Security benefits grow at a faster rate than salary, the amount of the benefit which is employer provided will continually decline.
4) Finally, since TEFRA, offset plans have become less popular with smaller employers.

However, a plan which uses a step rate formula should not have to reduce the Social Security benefit in plan calculations due to:

1) The Social Security determines the amount of extra benefit a person will receive rather than a reducing a benefit.
2) To receive the full amount of the step rate benefit, an employee is required to have 15 years of service with the employer

There are certainly improvements which could be made in our integration rules, especially in offset plans; however, HR3838 is misdirected and will not accomplish any positive results. By implementing the imposed fraction, it will cutback on retirement benefits and dollars for investment capital.

4. Percentage Test For Plan Coverage

A plan can meet the percentage test if it benefits at least 70% of all employees, or if at least 70% of all employees are eligible to participate, and the plan benefits 80% of those eligible to participate.

An alternate method is called the "fair cross section test". The IRS can determine that a plan covers a classification of employees that is found not to discriminate in favor of the prohibited group.

Thus, we have objective and subjective tests which have worked quite well for a number of years. The question is "Where is the discrimination?" I would be very reluctant to revert to any test that has no flexability such as the one initially considered by the House.

I commend HR3838 for recognizing that changing the existing guidelines might be counterproductive in addition to confusing; however, I question their action of requiring that the Department of the Treasury conduct a study on the preceived problem. This would be similar to asking the wolf to guard the chicken coop.

When looking at HR3838 as a total package, the results are:

1) Slows growth of investment capital
2) Cut back and/or freeze of benefits for rank and file employees
3) Plans become more expensive to administer
4) Confusion for employer and plan participants

Senator Nichols, thank you again for the opportunity to present these views and I trust they will be beneficial.

Senator NICKLES. Mr. Culver, thank you very much.

Next we have Gene Imke with Connecticut Mutual.

STATEMENT OF GENE IMKE, CONNECTICUT MUTUAL LIFE INSURANCE CO., OKLAHOMA CITY, OK; REPRESENTING THE OKLAHOMA CITY CHAPTER OF CERTIFIED LIFE UNDERWRITERS

Mr. IMKE. Thank you, Senator Nickles. With your permission I'm going to ask Ken Culver to bring you a final draft of my remarks.

Senator NICKLES. All right. Thank you.

Mr. IMKE. I'll hold them to 10 minutes.

I am Gene Imke and I'm a life underwriter from Oklahoma City. I operate as a small businessman in my sales work and employ two people. Many of my 1,500 policyowners are also small businessmen and women who employ on the average between 5 and 10 people.

I have had the opportunity to work on a close personal relationship with hundreds of business and individual clients annually for 24 years. I believe I have a good understanding of how most small businessmen and individuals feel about taxes and the relationship of Government to their business.

I have served as president of the 1,500 member Oklahoma State Association of Life Underwriters and the Oklahoma city Association of Life Underwriters. I served as trustee for the National Association of Life Underwriters, a federation of 1,100 State and local life underwriters associations. NALU represents over 130,000 career life underwriters from all parts of the United States.

My service with these three organizations has allowed me to meet and become close friends with many people operating businesses similar to mine throughout Oklahoma and across the United States. I am speaking today as immediate past president of the Oklahoma City Chapter of Chartered Life Underwriters and I believe my remarks also represent the other three organizations.

The best approach to this subject is to summarize the important points of the Reagan plan and H.R. 3838 and their effect on small business owners.

1. LIFE INSURANCE CASH VALUES

The Reagan plan will tax cash value increases as earned but only on new policies issued. H.R. 3838 keeps the current law which states that cash value increases are not taxed until a policy is surrenderd and only the gain is taxable. We believe current law to be best for small businessmen and our country.

2. ANNUITY CASH VALUES

The Reagan plan proposes to tax cash value increases as earned, again only in new contracts. H.R. 3838 will tax all corporate-owned annuity cash value increases, but will not tax the cash values of annuities owned individually until the cash value is paid out or withdrawn. We oppose any tax on annuity cash values, corporate or individually owned, until the cash values are removed.

3. PROCEEDS FROM POLICY LOANS

The Reagan plan did not specifically address this issue, but it would be affected by their proposal limiting the amount of consumer interest that can be deducted. H.R. 3838 does not tax loan proceeds. We oppose the Government taxing loan proceeds.

4. POLICY LOAN INTEREST

Again the Reagan plan does not specifically address this topic. H.R. 3838 allows policy loan interest to be deducted, and we support the continued deductibility of policy loan interest.

5. CONSUMER INTEREST

The Reagan plan limits annual nonbusiness interest deductions to $5,000 over and above net savings income. H.R. 3838 limits nonbusiness loan interest deductions to $10,000, or $20,000 on a joint return, over and above net savings income and allows interest deductions for mortgage interest on first and second homes. We oppose limiting interest deductions.

6. GROUP LIFE INSURANCE

The Reagan plan proposes current law be continued whereby employers may provide up to $50,000 of tax-free term life insurance benefits to employees. H.R. 3838 continues current law and we oppose any repeal of section 79 of the Internal Revenue Code.

7. GROUP HEALTH INSURANCE

The Reagan plan proposes to tax employees on the first $10 per month for an individual, $25 per month per family, on employer paid premiums. H.R. 3838 follows current law in allowing the premiums paid by employers for employee group health insurance benefits to be fully deductible by the employer and not taxable to the employee. We support this position.

Senator Nickles, most life underwriters are small businessmen and women. Many of us have small business clients. Both as a seller and as a buyer of life and health insurance, my colleagues, my clients, and I find the Reagan tax proposal unsupportable.

The greatest concern is the proposal to tax annual increases in cash values of permanent life insurance. This proposal, if accepted, will destroy permanent life insurance. The proposal is not—as Treasury claims—removal of a tax incentive. It is an imposition of a tax penalty.

Taxing life insurance cash values is like taxing appreciation in a home or a share of stock before it is sold. It is a tax on unrealized income, and there is no income created to pay the tax. As such, it is neither fair nor simple. It would destroy the market for permanent life insurance. It would fail to stimulate economic growth and would cripple or kill $1 trillion industry, the third largest domestic source of capital in our economy.

Senator Nickles, our focus here is on small business. Life insurance is the lifeline of small business, just as it is for families. Life insurance protection of the small business owner or key person is often the buffer that lets that business survive when the owner or key person dies too soon. Survival of the business means continued jobs, continued economic performance, less demand on welfare systems, and continued tax income to the Government.

If permanent life insurance is destroyed, I fear for the financial security of our society. Less than 1 percent of all term insurance results in a death claim. It is permanent life insurance that pays widows, widowers, orphans, and enables small employers to stay in business.

If great numbers of people choose to do without life insurance, the pressure on Social Security and other welfare programs would be enormous. If the Reagan plan is enacted, the level of life insurance protection of our society will drop dramatically.

Term insurance premiums rise as the policyholder ages to the point where most people cannot afford to keep it in force. If cash value increases become taxable, permanent life insurance will create a tax burden that exceeds any term costs by retirement time. It also becomes too expensive to maintain.

For example, consider a 35-year-old man who buys a $50,000 life insurance policy for $773 a year. By age 55, while the death benefit has increased to $100,809, he pays not only the $773 premium but the tax on $3,256. By age 75, it is even worse. His tax liability is on $26,121 and he still hasn't lived a normal life expectancy. These results would make it impossible or impractical to continue a life insurance program in old age when death becomes a certainty. Term insurance is too costly and the tax consequences of permanent insurance would be too great.

In regards to H.R. 3838, the wisdom of the House of Representatives prevailed and some of the provisions of the Reagan plan that were detrimental to individuals, small business, and our country's capital formation and success were eliminated. However, there should not be a tax on cash values from annuities until payout whether owned individually or by corporations. Nor, should there be any limitation on any nonbusiness loan interest deductions. Other than that, H.R. 3838, on life and health insurance issues appears to be favorable to all parties involved.

In summary, the Reagan tax reform insurance-related proposals are devastating to life underwriters who are small business people. From our perspective, they are unfair and complicated. They not only fail to promote our country's economic growth, they knock us flat out of business and shift an even greater burden to the Federal Government.

Senator Nickles, if you or any of your committee members would like detailed information papers on any of the topics of my discussion I will see that they are furnished to you. I'll be happy to answer any questions you may have, and thank you very much for the opportunity to share our concerns.

[The prepared statement of Mr. Imke follows:]

STATEMENT OF

GENE R. IMKE, CLU
OKLAHOMA CITY CHAPTER
OF
CHARTERED LIFE UNDERWRITERS

ON

SMALL BUSINESS CONCERNS ABOUT TAX REFORM

Oral Statement

Thank you, Senator Nickles and members of the Senate Small Business Committee. I am Gene Imke, a life underwriter from Oklahoma City. I operate as a small businessman in my sales work and employ two people. Many of my 1,500 policyowners are also small businessmen who employ, on average, between five and ten people.

I have had the opportunity to work on a close personal relationship with hundreds of business and individual clients annually for 24 years. I believe I have a good understanding of how most small businessmen and individuals feel about taxes and the relationship of government to their business.

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2) Annuity Cash Values--The Reagan Plan proposes to tax cash value increases as earned, again only in new contracts. HR3838 will tax all corporate-owned Annuity cash value increases, but will not tax the cash values of Annuities owned individually until the cash value is paid out or withdrawn. We oppose any tax on Annuity cash values, corporate or individually owned, until the cash values are removed.

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In summary, the Reagan tax reform insurance-related proposals are devastating to life underwriters who are small business people. From our prospective, they are unfair and complicated. They not only fail to promote our Country's economic growth, they knock us flat-out of business and shift an even greater burden to the federal government.

Senator Nickles, if you or any of your committee members, would like detailed position papers on any of the topics of my discussion, I'll see that they are furnished to you or you can call Danea Kehoe Martin over at NALU headquarters (202) 331-6058. I'll be happy to try to answer any questions you may have. Thank you for this opportunity to share our concerns.

Respectfully submitted,

R. Imke

Senator NICKLES. Mr. Imke, thank you very much. Mr. Thielke.

STATEMENT OF JAMES E. THIELKE, CPA, TAX PARTNER, PEAT, MARWICK, MITCHELL & CO., OKLAHOMA CITY, OK; REPRESENTING THE OKLAHOMA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. THIELKE. Thank you, Senator. I am Jim Thielke, a partner with Peat, Marwick, Mitchell & Co. I'm representing the Oklahoma Society of CPA's in my comments today.

Tax reform proposals offered by the administration in May and the bill passed by the House of Representatives in December contain many provisions that affect investment and capital formation in the United States. Although both these proposals contain provisions lowering the maximum rate at which corporations may be taxed, the broadening of the corporate tax base through an expanded minimum tax, and reductions in capital cost recovery deductions, as well as the repeal of the investment tax credit, will result in an overall increase in corporate taxes. Economists project that the after-tax cost of capital under the House bill will increase by about 15 percent as a result of the repeal of the investment tax credit and the reduction in depreciation benefits, and the repeal of the investment tax credit has the most dramatic effect.

It is important to remember that the provisions under either proposal cannot be looked at in isolation. For example, many people argue that the increase in corporate taxes will be offset by a decrease in personal tax rates. A decrease in personal tax rates should free up funds for savings and investment. On the surface, that at least appears to be a shift in taxation from the noncorporate sector to the corporate sector; however, what would actually occur is merely a shift from the taxes that we as individuals make in the form of payroll withholdings, or the tax check that we write in April to taxes paid by us indirectly in the form of higher prices for corporate products, lower dividends, and fewer jobs. In effect, there is no substantive reallocation between the sectors but, rather, only a change in the form in which the tax is paid.

Both proposals would also result in a reallocation of the tax burden among the various classes of investment alternatives. In the absence of taxes, the operation of a competitive economy would cause capital to flow to sectors where it is expected to earn the greatest rate of return. Nonneutral tax provisions artificially draw capital to lightly taxed sectors. Under present law, the combination of the investment tax credit and accelerated depreciation for property in the 3- and 5-year classes are roughly equivalent in terms of present value to deducting the full cost of property in the year of acquisition. Expensing treatment effectively eliminates corporate level tax on income from equipment investments. The House bill by repealing the investment credit and stretching out depreciation deductions will reduce the value of the capital recovery provisions to less than expensing treatment, thereby reducing the attractiveness of equipment investment.

Close scrutiny should also be given to the effect of the proposal on industry sectors. The House bill curtails certain benefits for oil and gas at a time when the domestic industry needs additional incentives to explore for additional reserves and alternate energy sources. The reduction in these tax benefits is especially harsh treatment in view of the substantial decline in prices.

In the agricultural area, certain benefits, such as the current deduction for land clearing expenses, and certain soil conditioning expenditures are repealed. However, the expensing of preproduction period expenses which family farmers have found to be most critical is retained. The House bill also sharply curtails the benefits of agricultural tax shelters, which will hopefully reverse the trend in which the young family farmer has been priced out of the market by tax shelter investors.

As heard earlier today, the banking industry will be hit hard by the curtailment of the ability of large commercial banks to take deductions for loan losses. In addition, banks will effectively include in taxable income the interest that they receive on tax-exempt obligations. This will be particularly detrimental to the municipal bond market where banks have traditionally made major investments. If the municipalities cannot market their bond issues, construction of schools, roads, sewers, et cetera will be cut back and jobs will be lost. Similar consequences will follow from the curtailment of the volume of private purpose bonds that may be issued under the House bill.

Several provisions relating to the method of accounting used by businesses will also impact on the dollars available for capital investment in the United States. Proposed restrictions on the use of the cash method of accounting will impose significant additional overhead costs for many smaller businesses. Changes in accounting provisions alone will cost U.S. corporations almost $60 billion over the next 5 years. And these provisions are second only to the capital income provisions in terms of the size of the impact on the corporate sector.

In terms of the small business or new business investor in any industry, it would appear that the effect of the proposals would be a dampening of the entrepreneurial spiral. Present law provides the small or new businessman with some assurance that the higher risks taken will be offset to some extent by favorable tax benefits in the early years. Both proposals remove some of these incentives.

Finally, the shortrun effects of both proposals must be scrutinized to determine any major discrepancies from the long-run effect. Discrepancies result primarily from two factors: The first is the uncertainty which arises anytime major tax legislation is pending. In this instance, capital investment may be accelerated into 1986 if it is anticipated that the effective date of the legislation will be January 1, 1987. The corollary would be a significant reduction in investment in 1987. The second reason for short-run disparity is the natural disruption caused by new legislation as capital investment shifts among sectors, assets, and industries.

There have been five major income tax bills, all heralded as tax reform and/or simplification in the last 9 years. It is unlikely that the entire economy has had time to adjust to any one bill before new legislation is pending. This unpredictability of tax structure and the high cost of keeping abreast of changes is an even harsher burden on the small businessman.

Unfortunately the industries paying the biggest price are those which have traditionally formed the major economic base in Oklahoma and the rest of the Midwest, primarily energy, agriculture, and banking.

We in Oklahoma are at the beginning of a recovery period in our economic cycle. At a time when we most need additional incentives for investment, the House and administration are offering us disincentives.

Recently we have been able to attract large companies, a recent one has been Hitachi, to our State. These are companies which can provide jobs and which have outstanding reputations for contributing to the community. This will be difficult if not impossible if the recovery in Oklahoma is reversed and the incentives for new investment are removed.

Thank you.

[The prepared statement of Mr. Thielke follows:]

STATEMENT OF

JAMES E. THIELKE
OKLAHOMA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
OKLAHOMA CITY, OKLAHOMA

ON

SMALL BUSINESS CONCERNS ABOUT TAX REFORM

The tax reform proposals offered by the Administration on May 29, 1985, and the bill passed by the House of Representatives on December 17, 1985 (H.R. 3838) contain numerous provisions that will affect investment and capital formation in the United States. Although both proposals contain provisions lowering the maximum rate at which corporations may be taxed, the broadening of the corporate tax base through an expanded minimum tax and reductions in capital cost recovery reductions, as well as the repeal of the investment tax credit, will result in an overall increase in corporate taxes. Economists project that the after tax cost of capital under the House bill will increase by about 15% as a result of the repeal of the investment tax credit and the reduction in depreciation benefits, with the repeal of the credit having the most dramatic effect.

It is important to remember that the provisions under either proposal cannot be looked at in isolation. For example, many will argue that the increase in corporate taxes will be offset by the decrease in personal income tax rates. A decrease in personal rates should free up funds for savings and investment. On the surface there appears to be a shift in taxation from the noncorporate sector to the corporate sector. However, what would actually occur is merely a shift from taxes that we as individuals make in the form of payroll withholding or the tax check we write in April to taxes paid by us indirectly in the form of higher prices for corporate products, lower dividends, or fewer jobs. In effect, there is no substantive reallocation between the sectors, but rather only a change in the form in which the tax is paid.

Economists also suggest that the reduction in capital formation incentives proposed by the House bill could lead to an increase in the U.S. trade deficit of as much as $10 billion annually. Economist Roger Brinner of Data Resources, Inc. suggests that the overall cost of U.S. manufactured goods compared to foreign products would rise by 5% or 6%, an increase that probably would be offset by an equal reduction in the value of the dollar. However, Lawrence Chimerine of Chase Econometrics predicts that the overall cost of U.S. goods would still increase by 2%. The effective tax rate for foreign investors in U.S. corporate assets will be further increased relative to U.S. investors because foreign investors would not directly benefit from the offsetting individual tax reductions.

In addition to some reduction in the level of capital investment, both proposals would result in a reallocation of the tax burden among the various classes of investment alternatives. In the absence of taxes, the operation of a competitive economy would cause capital to flow to sectors where it is expected to earn the highest rate of return. Non-neutral tax provisions artifically draw capital to lightly taxed sectors. Under present law, the combination of the investment tax credit and accelerated depreciation for property in the 3- and 5-year classes are roughly equivalent, in present value, to deducting the full cost of the property in the year of acquisition. Expensing treatment effectively eliminates corporate-level tax on income from equipment investments. The House bill, by repealing the investment credit and stretching out depreciation deductions, will reduce the value of the capital recovery provisions to less than expensing treatment, reducing the attractiveness of equipment investment.

Close scrutiny should also be given to the effect of the proposal on industry sectors. For example, the House bill curtails certain tax benefits for oil and gas at a time when the domestic industry needs additional incentives to explore for additional reserves and alternate energy sources. The reduccion in these tax benefits is especially harsh treatment in view of the substantial decline in prices.

In the agricultural area certain benefits, such as current deductions for land clearing expenses and certain soil conditioning expenditures, are repealed. However, the expensing of preproduction period expenses, which family farmers have found to be most critical, is retained. The House bill also sharply curtails the benefits of agricultural tax shelters which will hopefully reverse the trend in which the young family farmer has been priced out of the market by tax shelter investors.

The research and development credit is extended for three years, but the definition of qualifying activities is tightened so that only true research, including university research, will benefit.

The rehabilitation credit which has played a key role in encouraging investment to revitalize decaying urban areas is retained as well as provisions allowing special treatment for investments in low-income rental housing such as tax-exempt bonds, depreciation deductions, and the application of the at-risk rules.

The banking industry will be hard hit by curtailment of the ability of large commercial banks to take deductions for loan losses. In addition, banks will effectively include in taxable income the interest received on tax exempt obligations. This will be particularly detrimental to the municipal bond market where banks have traditionally made major investments. If the municipalities cannot market bond issues, construction of schools, roads, sewers, etc., will be cut back and jobs will be lost. Similar consequences will follow from the curtailment of the volume of private purpose bonds that may be issued under the House bill.

Several provisions relating to the method of accounting used by businesses will also impact on the dollars available for capital investment in the United States. Proposed restrictions on the use of the cash method of accounting will impose significant additional overhead costs for many smaller businesses. Changes in accounting provisions alone will cost U.S. corporations almost $60 billion over the next five years and are second only to the capital income provisions in terms of the size of the impact on the corporate sector.

In terms of the small business or new business investor in any industry, it would appear that the effect of the proposals would be a dampening of the entrepreneurial spirit. Present law provides the small or new businessman with some assurance that the higher risk taken will be offset to some extent by favorable tax benefits in the early years. Both proposals remove some of these incentives.

Finally, the short-run effects of both proposals must be scrutinized to determine any major discrepancies from the long-run effect. Discrepancies result primarily from two factors. First is the uncertainty which arises any time major tax legislation is pending. In this instance, capital investment may be accelerated into 1986 if it is anticipated that the effective date of the legislation will be January 1, 1987. The corollary would be a significant reduction in investment in 1987. The second reason for short-run disparity is the natural disruption caused by new legislation as capital investment shifts among sectors, assets, and industries. There have been five major income tax bills, all heralded as tax reform, in the past nine years. It is unlikely that the entire economy has had time to adjust to any one bill before new legislation is pending. This unpredictability of the tax structure and the high cost of keeping abreast of the changes is an even harsher burden on the small businessman.

Unfortunately, the industries paying the highest price are those which have traditionally formed the major economic base in Oklahoma and the rest of the mid western region; i.e., energy, agriculture and banking. We in Oklahoma are at the beginning of a recovery period in our economic cycle. At a time when we most need additional incentives for investment, the House and the Administration are offering us disincentives. Recently, we have been able to attract large companies such as Hitachi, Ltd., to our state, companies which can provide jobs and which have outstanding reputations for contributing to the community. This will be difficult if not impossible if the recovery in Oklahoma is reversed and the incentives for new investment are removed.

Senator NICKLES. Mr. Thielke, thank you and to all of our panelists, thank you. Just a couple of quick questions before you leave.

Mr. Thielke, you mentioned the cash method of accounting for small businesses. I think that in the House bill, it kept it for any businesses with, what, sales under $5 million?

Mr. THIELKE. Gross receipts of under $5 million; yes.

Senator NICKLES. Is that threshold high enough?

Mr. THIELKE. I think that we have clients who I would consider to be small business who have gross receipts in excess of $5 million who would have to change their method of accounting. Presently they have no requirement, certain industries at least, no requirement to use generally accepted accounting principles which would require accrual accounting, and if these proposals are enacted they would have to change their method of accounting to accrual method of accounting. Their reports that they use for management purposes are based on a cash basis, and that's what they understand. And we would be forcing them to make a change if these proposals were enacted.

Senator NICKLES. What do you think a proper threshold amount would be?

Mr. THIELKE. Probably in the $15 to $20 million range.

Senator NICKLES. OK. I would—as a small business person with a background—of course I had a manufacturing business, so we were on accrual, anyway, but I could still see where professionals and many others who have been accustomed to cash method of accounting would want to stay there, and I would hope that we would.

A couple of other just quick questions.

Mr. Imke, you mentioned the House bill, I believe would place a tax on the cash value of annuities; is that correct? As the cash value would increase if they were purchasing an annuity from Connecticut Mutual or whoever, that they would have to pay taxes on that increase of the cash value?

Mr. IMKE. That's right, corporate-owned annuities.

Senator NICKLES. So, they exempted increases on cash values from whole life insurance, but they were taxing cash value increases on annuities?

Mr. IMKE. Corporate-owned annuities.

Senator NICKLES. Corporate-owned annuities?

Mr. IMKE. They left the individual annuities—annuities that were individually owned—alone.

Senator NICKLES. If Nickles Machine Corp. is purchasing an annuity for our pension participants, so they had a cash value increase, that would be taxed on under the House proposal?

Mr. IMKE. I'm not positive. I believe it would fall under the tax shelter of the pension plan.

Senator NICKLES. Ken, I see you shaking your head.

Mr. CULVER. No, Senator, those, you're talking about corporate-owned individual annuities outside of a retirement plan. They would be taxed.

Senator NICKLES. Aren't most annuities purchased within a retirement plan?

Mr. CULVER. Yes; most of them are inside a retirement plan. They were not referring to those.

Senator NICKLES. OK. Ken, just a quick question. You've done a lot of work, and I appreciate your statement dealing with 401(k)'s and pension rules in general.

I also spent a lot of time in there. You alluded to the discrimination rules. Those are rules that can put this Senator to sleep and I think most anybody else. Don't you see those as really being an extremely burdensome ordeal for particularly, I guess, small- to medium-sized businesses as far as making sure that they continue to qualify?

Mr. CULVER. Absolutely, Senator. This is just another thing of—there has been no pattern of discrimination in this area shown in the past, so why burden the small employer? Obviously if he wanted to be a specialist in retirement plans, he wouldn't be doing what he was doing, but it's almost saying to the small employer, you've got to become more involved in this, and, therefore, spends less time in doing the things that make you money.

Senator NICKLES. There's just pages and pages of rules in the bill being statutory, dealing with discrimination as far as making sure you'd have a qualified plan, and I could see people pulling their hair out to determine whether this class or this segment or this group would still be qualified.

Mr. CULVER. Particularly the repeal of the classification test, the fair cross section right now. That would really take out a situation where you just can't legislate everything, there has to be something left up to fair analysis.

Senator NICKLES. I understand. One final comment. You alluded to it in your statement. The coordination on 401(k)'s and IRA's, and to having the first dollar drop off, I guess, if you contribute $1 in 401(k), that's $1 that you could not contribute under an IRA. I find that particularly objectionable.

Mr. CULVER. Absolutely, Senator. There's just—there doesn't appear to be any sound reason for that, other than looking for tax dollars, and it's another area where there should be some large questions on whether tax policy and retirement policy should be looked at as one item.

Senator NICKLES. I would concur with that. And I think there were several attempts by both the administration proposal and the

House proposal to implement pension policy, and they were using the Tax Code to do it, and adversely in this Senator's opinion dealing with the private pension system.

One final comment on the 401(k)'s, the House proposal put in a limit of $7,000 coordinated with IRA's. Present law, I guess, would be $30,000. Do you have a dollar amount that you think would be more appropriate?

Mr. **Culver**. From what we've been able to tell, there are not very many that are going over the $10,000 to $15,000 range, anyway. And even a spokesman from the Treasury Department said over the $10,000 range, there is very, very little loss of revenue. So somewhere in the $10,000 to $15,000 range.

Senator **Nickles**. Mr. Graves, one final question for you. You mentioned you represent the Oklahoma Independent Producers Association with 1,500 members.

How does your membership compare to 2 or 3 years ago?

Mr. **Graves**. Our membership is falling quite rapidly here in the last—well, in fact just about the last 2 months. Our high was somewhere over 1,600. We did get—then our membership got down to somewhere around 1,200, and then we brought it back up by going out and, you know, soliciting new members, support groups, banks, service companies, accountants, lawyers, and that sort. So, that probably has been the reason that our membership is back up to 1,500.

Senator **Nickles**. How many rigs are running in Oklahoma today?

Mr. **Graves**. Less than 250. On a day like today, I'd say there's very few running.

Senator **Nickles**. But on a normal, average weather day, less than 250?

Mr. **Graves**. Yes, sir.

Senator **Nickles**. What did you have at a peak time in 1982?

Mr. **Graves**. 1982, we had over 880. We'll be—I'd say the industry will be fortunate if we can sustain 200 rigs through the rest of this year, and I'm really doubtful that we can, because of the combination, you know, of adverse circumstances that we're now facing. It's all—you know, everyone's throwing rocks at us and we can't tell how many of them are hitting us, but we know a lot of them are.

Senator **Nickles**. I appreciate your comments. To all of our panel, I appreciate your statements and your efforts to join us today. Thank you very much.

Our next and final panelists, we have Roy Avants, the Baer Co. in Oklahoma City, representing the Oklahoma City Board of Realtors, and Maurice Box with Box IGA in Tahlequah.

Julius Kubier is not here, I don't believe, and Frederick Drummond was unable to make it due to the weather.

Mr. Avants, thank you very much for joining us.

STATEMENT OF ROY AVANTS, THE BAER CO., OKLAHOMA CITY, OK; REPRESENTING THE OKLAHOMA CITY BOARD OF REALTORS

Mr. AVANTS. Thank you, Senator Nickles, for the opportunity.

I represent the Oklahoma City Metropolitan Board of Realtors, a membership of about 2,600 people here in Oklahoma City.

H.R. 3838 contains many provisions which we feel will be detrimental to homeownership and real estate investment. While there are some provisions which we can support, the overall balance of this bill is excessively adverse to homeowners or real estate investors. We shall attempt to present our position clearly and concisely.

We support the provisions of the bill which preserve current full deductibility of State income, sales and local property taxes.

The disallowance of the $500 itemized deduction per family member should be changed or eliminated. If allowed to stand, this results in homeownership being more expensive for families with children than for singles or childless couples. This cost increase is attributable to the deduction disallowance which would affect deductible mortgage interest expense. The relative impact on homeownership costs is greater for the low and middle income homeowners than for upper income homeowners.

Mortgage and investment interest deduction on a homeowner's first two residences is necessary. The limitation of $20,000 joint or $10,000 single in interest expense on all other nontrade or business interest expenses, including personal loans and interest passed through a limited partnership, will result in a reduction in the after-tax yield on a typically leveraged real estate investment.

The change in the depreciation rules could be especially harmful. H.R. 3838 makes a change to 30-year straight line from 19-year accelerated. This is excessive. The present value of depreciation deductions would be 63 percent lower at 30-year straight line over a 10-year holding period. This could result in an increase of $40 per month for the average apartment dweller, which we feel like would be excessive.

Capital gains taxation rate would be increased from 20 percent to 22 percent, and would apply to all sales as of January 1, 1986. No transitional relief would be allowed. This retroactive effectiveness unfairly penalizes investors for basing their investment decision on a law that existed at the time of their investment.

I believe, Senator Nickles, you expressed a very direct comment on that while ago, and we do appreciate that.

Senator NICKLES. Thank you.

Mr. AVANTS. The alternative minimum tax provision must be carefully studied. While we favor a minimum tax for individuals with a substantial annual income, the alternative minimum tax provisions of H.R. 3838 are so broad that it would render many of the regular tax investment incentives meaningless.

The effective dates and transition rules must not be allowed to create confusion with regard to investment decisions. The House bill schedules effective date of January 1, 1986, for most provisions.

However, reduction of personal and corporate tax rates would not take place until July 1, 1986. One provision has an effective date of January 1, 1987, quite a confusion.

Because of these unsettled dates, real estate investment decisions for almost a full year would be either foregone or distorted because of current provisions.

We appreciate this opportunity to make our views known to you. Thank you.

[The prepared statement of Mr. Avants follows:]

REALTOR® **OKLAHOMA CITY METROPOLITAN BOARD OF REALTORS, INC.**
2919 United Founders Boulevard 73112
Telephone: 840-1493

POSITION STATEMENT OF THE
OKLAHOMA METROPOLITAN BOARD OF REALTORS
ON H.R. 3838/TAX REFORM LEGISLATION

H.R. 3838 contains many provisions which we feel would be detrimental to homeownership and real estate investment. While there are some provisions which we can support, the overall balance of this bill is excessively adverse to the homeowner or real estate investor. I shall attempt to present our position clearly and concisely.

1. We support provisions of the bill which preserve current full deductibility of state income, sales, and local property taxes.

2. The disallowance of the $500 itemized deduction per family member should be changed or eliminated. If allowed to stand, this results in home ownership being more expensive for families with children than for singles or for the childless couple. This cost increase is attributable to the deduction disallowance which would affect deductible mortgage interest expense. The relative impact on homeownership costs is greater for low and middle income homeowners than for upper-income owners.

3. Mortgage and investment interest deduction on a homeowner's first two residences is necessary. The limitation of $20,000 (joint) or $10,000 (single) in interest expense on all other nontrade or business interest expense, including personal loans and interest passed through a limited partnership, will result in a reduction in the after-tax yield on a typically leveraged real estate investment.

POSITION STATEMENT OF THE
OKLAHOMA METROPOLITAN BOARD OF REALTORS
Page Two

4. The change in depreciation rules could be especially harmful. H.R. 3838 makes a change to 30-year straight line from 19-year accelerated. This is excessive. The present value of depreciation deductions would be 63% lower at 30-year straight line over a 10 year holding period. This could result in an increase of $40 per month for the average apartment dweller.

5. Capital gains taxation rate would be increased from 20% to 22% and would apply to all sales as of January 1, 1986. No transitional relief would be allowed. This retroactive effectiveness unfairly penalizes investors for basing their investment decision on law that existed at the time of their investment.

6. Alternative minimum tax provisions must be carefully studied. While we favor a minimum tax for individuals with substantial annual income, the AMT provisions of H.R. 3838 are so broad that it would render many of the regular tax investment incentives meaningless.

7. H.R. 3838 would repeal the 15% and 20% rehabilitation tax credit along with the 25% historic tax credit. Instead, historic structures would be allowed a credit of 20%. Nonhistoric structures constructed prior to 1935 will receive a 10% credit. Our position is to leave the historic and rehabilitation tax credits as they now stand.

8. Effective dates and transition rules must not be allowed to create confusion with regard to investment decisions. The House Bill schedules effective date of January 1, 1986 for most provisions. However, reduction of personal and corporate tax rates would not take effect until July 1, 1986. One provision has an effective date of January 1, 1987. Facing reality, tax reform legislation will not be completed by the Senate until at least mid-year 1986.

REAL ESTATE INVESTMENT DECISIONS FOR ALMOST A FULL YEAR WOULD BE EITHER FOREGONE OR DISTORTED BECAUSE OF CURRENT PROVISIONS.

We appreciate this opportunity to make our views known to the U.S. Senate.

Roy M Avants

Roy Avants, President
Oklahoma City Metropolitan
Board of REALTORS

Senator NICKLES. Thank you very much.
Mr. Box.

STATEMENT OF MAURICE BOX, BOX IGA, TAHLEQUAH, OK; REPRESENTING THE OKLAHOMA RETAIL GROCERS ASSOCIATION

Mr. Box. Thank you, Senator. I'm delighted to be here today to offer you the views of the National Grocers Association, and the Oklahoma Retail Grocers Association.

I know I need not stress to this committee the major importance of small business. You know the record well.

Retail grocers and other small business are a segment of the small business community characterized by growth oriented expansion. These firms are of vital importance to the entire Nation and their particular problems and requirements must be constructively addressed.

We endorse the Senate Finance Committee's reported decision to start anew the tax reform process. While some constructive efforts have been made in the House, very considerable creative and innovative work remains to be done. The House bill H.R. 3838 seriously violates basic principles of tax reform. First, the interaction of corporate rate reduction and ITC elimination is economically unwise. In the public and political excitement over tax reform, there has been little serious examination of the micro- and macroeconomic consequences of the bill. In fact, when one examines the numbers, the results are most discouraging. Elimination of the ITC delivers a serious blow to growth oriented, expanding and constructive business persons.

After extensive study and analysis, Prof. Craig Roberts concluded that loss of the ITC has the largest impact on the cost of capital. It would increase the cost of equipment by 16.5 percent, the cost of structures by 4.2 percent, and nonresidential fixed investment by 11.2 percent.

Nor are these costs at all effectively compensated for by the reduction in rates which are primarily in the upper brackets. No wonder that a recent comprehensive study of the NGA membership revealed that 87 percent of the respondents said loss of the investment tax credit would slow or impede their business growth. Consequences of this type affect us all through their adverse impact upon the Nation's economy. No matter how attractive the rhetoric of tax reform, it cannot justify realities such as these.

Second, the interaction of corporate rate reduction and ITC elimination is unfair. For example, the combination of rate reduction and ITC repeal would increase taxes for businesses with income levels of 50,000 or 100,000 by as much as 32 percent.

On the other hand, companies at the 10 million or $100 million annual level would enjoy reduction of more than 12 percent.

By distributing its benefits in a regressive, rather than a progressive manner, H.R. 3838 creates serious competitive imbalances and inequities in the supposedly free marketplace. These disruptions can only seriously damage the future of small business.

Too often elimination or retention of the ITC has been viewed as an all-or-nothing proposition. In fact, innovative legislative modifications are distinctly possible.

Thus, after substantial research and analysis, our association has introduced the concept of a modified, targeted ITC. Let me explain to you its essential features: No. 1, the imposition of a progressive structure of capital cost incentives such that as investments increase, the taxation credits attached to them would decrease.

Two, the substantial reduction or elimination of credit incentives at the upper end of the scale.

Consider only one possible example of this concept. In this model, the first $1 million of investment purchases would receive an ITC of 10 percent. The second $1 million of investment purchases would receive an ITC of 8 percent. The next $3 million increment would receive credits of 6 percent, 4 percent, and 2 percent respectively, with all additional investment purchases being eligible for a 1-percent ITC.

Of course this is only one model of a far broader concept. A final determination of the specific taxation rate incentive structure would balance beneficial investment stimulus with equity and cost considerations.

Small business response has been uniformly enthusiastic. Indeed after a careful review, the Small Business Legislative Council formally approved inclusion of the concept in any future tax reform legislation. Endorsements such as these points your way to future action.

Of course, this will require further critical examination and analysis; indeed, that is the very role of today's hearing. But we strongly believe that the idea, itself, is one whose time has definitely come.

There is one final point that I'd like to raise, and I think you've already covered this, Senator, but I'll go ahead. We hope that you in Washington, DC, realize that constant legislative changes and modification results in serious doubts and uncertainties for millions of businessmen and women, both large and small. Our inability to plan with confidence inevitably operates to chill and retard constructive investments. We strongly urge the leaders of both the House and Senate to clearly guarantee that any important changes to the Tax Code will be enacted at a prospective date. Elimination of any possible retroactivity would greatly spur our own willingness to move ahead with constructive expansion.

Mr. Chairman, I'd like to thank you and extend my appreciation and that of the National Grocers Association, and the Oklahoma Retail Grocers Association for your invitation to testify here today.

[The prepared statement of Mr. Box follows:]

STATEMENT
OF

MAURICE BOX
BOX IGA FOOD STORES
TAHLEQUAH, OKLAHOMA

ON BEHALF OF THE

NATIONAL GROCERS ASSOCIATION
AND
OKLAHOMA RETAIL GROCERS ASSOCIATION

BEFORE THE

SENATE SMALL BUSINESS COMMITTEE

FEBRUARY 10, 1986

Mister Chairman, I am Maurice Box, owner and Chairman of Box IGA Food Stores, in Tahlequah, Oklahoma. Box IGA Food Stores, like many Oklahoma and N.G.A. members, operates retail food stores, ranging from conventional supermarkets to convenience stores. Today, I hope to share with you some of my insights and experience resulting from 50 years of involvement in the retail food business.

I am delighted to be here today to offer your Committee the views of the National Grocers Association and the Oklahoma Retail Grocers Association on the critical issue of national tax reform. The National Grocers Association is the national trade association representing the small business sector of the retail and wholesale food distribution industry. Its members include over 2,000 retail grocers and sixty-two wholesale distribution companies serving 28,000 food stores.

The Oklahoma Retail Grocers Association, represents over 1,400 retail members operating throughout the state and in all 77 counties. These Oklahoma retail grocers, like myself, serve as the cornerstone of many Oklahoma communities' small business enterprises and what is true here today in Oklahoma is most certainly true nationally.

I know I need not stress to this Committee the major importance of small business to the American economic well being. You know the record well. By virtually any measuring stick, whether it be employment generation, expansion of sales, or improvements in customer servicing, small business has led the way in producing prosperity and progress.

What I do feel the Committee and the American people must realize is that the "small business" community itself is not some single, monolithic entity. "Small business" is actually hundreds and thousands of small businesses, each with its own characteristics and priorities. Thus, sweeping judgments that an individual policy is "good" or "bad" for small business as a whole should be viewed with real skepticism. Reflecting that truth, the focal point of recent N.G.A. analysis has been that segment of the small business community characterized by growth oriented, constructive, expansion policies and practices. This group of firms are of vital importance to the entire nation. Their particular problems and requirements must be constructively addressed.

Within this context, the N.G.A. endorses the Senate Finance Committee's reported decision to start "anew" the tax reform process. While some constructive efforts have been made in the House, very considerable creative and innovative work remains to be done. To allow the previously passed House proposals to serve as the effective basis for future legislation simply because they were "already there" would be a major mistake.

This is so because the House bill (H.R. 3838) seriously violates basic principles of tax reform which the National Grocers Association has consistently endorsed and fought for.

To be specific. First, the interaction of corporate rate reduction and ITC elimination is economically unwise. In the public and political excitement over "Tax Reform," there has been little serious examination of the micro and macro economic consequences of the bill. As Professor Craig Roberts, Chairman of the Institute for Political Economy recently testified before the Senate Finance Committee:

> "...neither the Administration nor the Congress has studied the impact that these changes would have on the cost of labor and capital in the United States; on the competitive position of U.S. goods and services in markets at home and abroad; or on individual troubled sectors of the economy such as agriculture. The best that the White House could do at a critical juncture in the debate was to produce two administration economists who declared that the bill would not cause a recession in 1986--hardly an endorsement. Indeed, the bill was supported by the President and passed by the House with everyone completely in the dark as to the bill's overall and specific economic impact."

In fact, when one examines "the numbers" the results are most discouraging. It has become increasingly clear that elimination of the ITC delivers a serious blow to the growth oriented, expanding, constructive business persons. After extensive study and analysis Professor Craig Roberts concluded that:

> "Loss of the ITC has the largest impact on the cost of capital. It would increase the cost of equipment by 16.5 percent, the cost of structures by 4.2 percent, and nonresidential fixed investment by 11.2 percent."

Nor are these costs at all effectively compensated for by the reduction in rates, which are primarily in the upper brackets. No wonder that a recent comprehensive survey of the N.G.A. membership revealed that, "87% of the respondents said loss of the investment tax credit would slow or impede their business growth." Consequences of this type are not simply limited to the individual businesses involved. They effect all of us through their adverse impact upon the nation's economy. For example, a recent study by Professors Meyer, Prakken, and Varvares concluded that by 1991 the House bill would result in a level of GNP 2.3% lower than under present law and unemployment 1.1% higher. No matter how attractive the rhetoric of tax reform it cannot justify realities such as these.

Second, the interaction of corporate rate reduction and ITC elimination is unfair. Thorough examination of the data reveals that while all businesses must surrender the ITC, the corresponding tradeoff of lower corporate income tax rates benefit corporations in the higher brackets to a far greater degree.

Consider the following table:

Total Federal Income Tax

Taxable Income	Current Law	H.R. 3838 As Is	Percent Change
$ 50,000	$ 5,000	$ 7,500	+ 30.4%
100,000	20,750	22,750	+ 9.6%
250,000	82,250	84,250	+ 2.4%
500,000	184,000	180,000	- 2.6%
1,000,000	389,000	360,000	- 7.6%
10,000,000	4,100,000	3,600,000	- 12.2%
100,000,000	41,000,000	36,000,000	- 12.2%

(Chart assumes a progressive corporate investment pattern of 50% of taxable income resulting in an investment tax credit equal to 5% of taxable income. Minor expensing alterations are not considered.)

In short, H.R. 3838 distributes its benefits in a regressive rather than a progressive manner.

In summary, Mister Chairman, the investment tax credit plays a critical role in providing essential incentives for constructive business investment. This does not mean that the ITC must remain carved in present legislative stone. Too often elimination or retention of the ITC has been viewed as an "all or nothing" proposition. In fact, the National Grocers Association believes that constructive, innovative legislative modifications and refinements are distinctly possible.

Thus, after substantial research and analysis our Association has introduced the concept of a modified, targeted ITC.

Let me explain to you its essential features: one, the imposition of a progressive structure of capital cost recovery incentives such that as investments increase, the taxation credits attached to them would decrease; and two, the substantial reduction or elimination of credit incentives at the upper end of the scale.

Consider only one possible example of this concept. In this model, equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income. In specific, the first $1 million of investment purchases would receive an ITC of 10%, the second $1 million 8%, the next three million dollar increments would receive credits of 6%, 4%, and 2% respectively, with all additional investment purchases being eligible for a 1% ITC.

Of course this is only one model of a far broader concept. A final determination of the specific taxation rate incentive structure would balance beneficial investment stimulus with equity and cost considerations.

To provide for a far more thorough analysis and explanation of the N.G.A. concept and potential models thereof, I have appended to my testimony a copy of our Association study, Small Business and National Tax Revision Proposals: 1986.

Mister Chairman, the N.G.A. strongly supports this constructive policy concept. We believe that it would restore effective investment incentives for the constructive small business most in need of them. In addition, as statistical analysis clearly demonstrates, it would much more fairly distribute the benefits of ITC incentives coupled with rate reductions to all

American businesses, both large and small. Finally, by focusing upon the "lower end" of the scale it would provide such advantages at a minimal cost to the Treasury. Indeed, the undoubted ability of this more sophisticated mechanism to actually work in promoting investment employment and growth would make such limited expenditures highly cost-beneficial and cost-effective.

The imaginative concept set forward here represents a serious constructive effort to produce a meaningful capital cost recovery system for the growth oriented members of the small business community. Response has been uniformly enthusiastic. Indeed, after careful review the Small Business Legislative Council formally approved inclusion of the concept in any future tax reform legislation. Endorsements such as these are most encouraging.

Of course, the actual transformation of the concept of a limited, targeted ITC into legislative reality will require further critical examination and analysis. Indeed, that is the very role of today's hearing. But we at N.G.A. strongly believe that the idea itself is one whose time has definitely come.

There is one final point I would like to raise. Naturally, we endorse the extensive study and discussion which Congress is directing at the issue of tax reform. Such a process is essential to produce an optimal measure upon this important subject. But we hope that you in Washington, D.C. realize that such constant change and modification results in serious doubts and uncertainties for millions of businessmen and women, both large and small. Our inability to plan with confidence inevitably operates to seriously chill and retard constructive investments. Investment which would otherwise be fueling much-needed economic growth. We strongly urge the leaders of both the House and Senate to clearly guarantee that any important legislative changes in the tax code effecting investment decisions will be enacted at a prospective date. Elimination of any possible retroactivity would greatly spur our own willingness to move ahead with constructive expansion and growth plans and practices.

Mister Chairman, I should like to extend my appreciation and that of the National Grocers Association and Oklahoma Retail Grocers Association, for your invitation to testify here today. It is our hope that constructive and imaginative efforts from representatives of the private sector such as the N.G.A. and representatives of government such as your committee will produce genuine and meaningful tax reform for all of the American people.

SMALL BUSINESS AND NATIONAL TAX REVISION PROPOSALS: 1986

Submitted by
The National Grocers Association

I. Small Business

The historical role of small business in our society is without question. Successful small business was the original "American Dream." It has continued for more than 200 years to serve as the vital backbone of our entire American free enterprise system. Should anyone doubt the role which small business now plays they need only review the last three annual "State of Small Business" Reports of President Reagan, or the more detailed "Annual Report on Small Business and Competition" submitted by the Small Business Administration. Their hundreds of pages point out that in our economic downturns it is small business which has been most resistent to economic decline, and in our present recovery it is small business which has distinctly been in the forefront. Whether measured by employment generation, expansion of sales, improvement in service innovation, or any other basis, small business has led the way.

Yet despite this prominence, any attempt to give meaning and definition to the term "small business" is a most difficult one. Depending upon the authority or report which is consulted "small business" may be measured by the size of the employed workforce, amount of assets, level of sales, totality of income, or other diverse categories. Who is right, who is wrong? It's hard to say. And yet, "we know it when we see it." Each day we inevitably encounter small businessmen and women from the corner drug store, to the local gas station to the neighborhood grocer or restaurant. All of them provide us with the services and products our life demands. In fact, in America today there is no simple definition of "small business." Rather what all of us see and rely upon, are hundreds and thousands of small businesses, each one with its own diverse set of characteristics and priorities.

Indeed, the only real generality which one can make about the small business community is that no generality is possible. This aspect needs to be stressed. Far too often public discussion, and that surrounding tax revision, has tended to treat "small business" as a single, monolithic entity about which sweeping universal judgements could be made. What was good for 51% of small business would automatically be "good" for all 100%. In reality, a more sophisticated approach would reveal that the total community consists of a diversity of segments. That is our specific concern within this report, to focus upon the proper role of government tax policy upon the progressive, growth and investment oriented segment of small business. This group of firms are still of vital importance to the entire nation and its particular problems and requirements must be positively addressed.

II. Present Deficiencies

At the current moment the Senate Finance Committee and subsequently the Senate as a whole, is about to take up the issue of tax revision. Certainly the working basis for that discussion will be the collection of proposals embodied in the House passed bill, H.R. 3838. We would contend that far too little attention has been paid to a number of that legislation's potentially substantial impacts upon numerous small businesses. These impacts are of sufficient severity that they demand correction through constructive action by the Senate. In offering an analysis of various results to be expected from enactment of H.R. 3838 or similar legislation we rely upon illustrations drawn from the progressive independent retail grocery industry. Numerous examples from other segments of the economy could be similarly advanced. The grocers have been selected because of the convenience of our own data base, and because of their representative nature. As President Ronald Reagan noted on two separate occasions, "I cannot think of a better example of small businesses' contribution to our country's economic well being than that of the independent retail grocer." as well as the fact that we "still epitomize small business." From such a representative background our own analysis of the approach suggested in H.R. 3838 has concluded:

> The interaction of corporate rate reduction and Investment Tax Credit elimination is unwise. A careful examination of the revised rate structures clearly shows that most businesses are unable to take significant advantage of the most substantial reductions in corporate rates, those at the very highest end of the scale,. Yet they will suffer the loss of their one primary and most frequently utilized incentive to constructively compete and expand through modernization, format innovation, and store expansion-- the Investment Tax Credit. Obviously, the ultimate losers in such cases will be the store owners themselves, a vital segment of the grocery community, and their customers who have trusted them to provide the high levels of service and convenience which their expertise and community interest permits. In such circumstances the entire country loses.

No wonder that a recent comprehensive survey of the N.G.A. membership revealed that, "87% of the respondents said loss of the investment tax credit would slow or impede their business growth." In short, economic investment, vital to this industry and to the nation as a whole will be critically retarded or eliminated by total repeal of the ITC. As noted previously, while no claim can or should be made that this is true for every small business, it is especially true for the many who are most open to progress and expansion through investment improvements.

Furthermore, the interaction of corporate rate reduction and Investment Tax Credit elimination is unfair. Thorough examination of the data reveals that all businesses must surrender the Investment Tax Credit, but that the corresponding tradeoff--lower corporate income tax rates--benefit corporations in the highest bracket to a far greater degree. Thus the benefits of the rate interaction are not distributed progressively, but rather regressively. Moreover, one must understand that while the ITC may be a sometimes valuable accounting tool of larger businesses, it is often an essential feature of their smaller-moderate competitors providing vital financial assistance for progressive efforts to serve their customers. In short, by failing to allocate its burdens and benefits in an equitable, evenhanded manner, the Ways and Means bill fails fundamental tests of fairness.

No matter how frequently one may verbalize these conclusions they always seem more striking when confronted head on, in hard numerical form. As the following chart graphically demonstrates H.R. 3838 with its inequitable combination of rate reduction and elimination of the ITC greatly produces an unfair, unequal result which must be corrected.

Total Federal Income Tax

Taxable Income	Current Law	H.R. 3838 As Is	Percent Change
$ 50,000	$ 5,750	$ 7,500	+ 30.4%
100,000	20,750	22,750	+ 9.6%
250,000	82,250	84,250	+ 2.4%
500,000	184,000	180,000	- 2.6%
1,000,000	389,750	360,000	- 7.6%
10,000,000	4,100,000	3,600,000	- 12.2%
100,000,000	41,000,000	36,000,000	- 12.2%

(Chart assumes a progressive corporate investment pattern of 50% of taxable income resulting in an investment tax credit equal to 5% of taxable income. Minor expensing alterations are not considered.)

In summary, progressive small businessmen and women in every walk of American life are seriously damaged by the principles embodied in H.R. 3838. Its reduction of general rates offers far greater benefit to those at the "top" of the scale than to those at the bottom or middle levels. Worse still, its total elimination of the Investment Tax Credit removes a crucial incentive to much needed expansion and growth.

III. Constructive Proposals

Given the nature of the experiences of so many small businessmen and women, and the ongoing critical role which some form of the Investment Tax Credit plays in their plans for progressive expansion and growth it would seem that the appropriate legislative task is one of modification and refinement, i.e. the protection and enhancement of all beneficial features, with a corresponding reduction or elimination of those less desirable aspects. Too frequently the present debate about investment incentives through the tax code has assumed an unrealistic "all or nothing" quality. Either you are totally for the present ITC or you are totally against it. There is no room for any middle ground. Shaping the debate in this fashion has serioulsy damaged the search for an intelligent compromise. After careful examination of the dataand relevant expert interpretation and analysis, the N.G.A. feels that such a compromise, such a middle ground does exist. It exists in the shape of the concept of a targeted, limited progressive ITC.

While the exact features of such an approach are subject to alteration, its main principles and direction are clear. (1) The imposition of a progressive structure of investment incentives. When translated into law this would mean that as investments increased the taxation credits attached to them would decrease. (2) The substantial reduction or elimination of credit incentivesat the upper end of the scale. (3) A determination of the various investment levels and taxation rate incentives based upon scales which would balance investment stimulus with equity and cost considerations. Such a proposal, if enacted would continue to provide vitally needed economic support for the expansion and growth of progressive small business with none of the waste, ineffiency and unfairness entailed in the present tax credit approach.

As we indicated previously, a variety of specific proposals are available. As models of the concept we have attached several specific appendices which set out possible implementation levels. Careful examination and review of their operations should reveal many of the initial potential benefits of this conceptual approach. (All data contained within these models was prepared by the accounting firm of Friedman and Fuller). See Appendix I, and II and III.

Obviously the model proposals which we have included are not set in stone. They simply represent individual examples of a broader, more fundamental concept. As such a number of their specific features are subject to modification and refinement (For example, the incremental rate differentials or the amount of purchases covered could be altered through differentials or the amount of purchases covered could be altered through different fromulas. Similarly, each example extends the Investment Tax Credit to all investments, no matter how high, at a level of 1%. Cost or effectiveness considerations might lead to an elimination of this provision or to the imposition of a final "cap" at a lower ceiling level). But the concept involved, that of a targeted, limited, cost-effective ITC remains clear. It rests upon four fundamental principles.

First, a targeted, limited ITC of the type described here would retain the empirically verified, beneficial investment incentives for progressive small business found in the present tax code. As we have already noted, while large numbers of the nation's small businesses neither require nor utilize the ITC, for a definite progressive segment it constitutes a vital life support mechanism for further expansion and growth--expansion and growth which are also of major importance to our national economic health. While retaining these elements, the proposal offers absolutely no incentives for abuse of the provisions on the part of the small business community. (To the extent that most small businesses do not now heavily utilize the flat 10% credit they would assuredly not be attracted by the progressive rates found in these proposals).

Second, targeted ITC's of the type described here when combined with various rate reduction proposals achieve a much more fair, much more equitable system than do the current rates of H.R. 3838. Such an emphasis upon fairness must be at the root of any and all consideration of massive tax code changes. Without it, the just principles of genuine tax reform are rapidly transformedinto the unfortunate political compromises and influence of old fashioned tax revision. As the numbers which we have enclosed make very clear, our refinements and limitations of the ITC would interact with rate reductions to drastically narrow the range of benefit so that all businesses would be treated fairly and justly.

Third, enactment of an investment system which is heavily progressive in its rate structure (and even potentially capped) eliminates the most costly and most questionable utilization of the ITC under the tax code. Some leading economic authorities have expressed serious reservations about the value and effectiveness of tax investment incentives at the "upper end" of the scale. They argue that the benefits of such provisions for the heavy "smokestack"industries have been neither obvious nor significant and that virtually all examples of abuse and misuse of these provisions occur at these levels. All such problems are eliminated or overwhelmingly reduced under our proposals.

Finally, as we noted in the previous paragraph, an ITC which is heavily progressive in its rate structure virtually eliminates the most costly elements of the present investment tax credit. For example, utilizing the most recent available data from IRS 1982 Corporation Source Book of Income we find that total corporate usage of the Investment Tax Credit in 1982 was $17.3 billion. But of that figure, $15 billion, or approximately 87%, was earned by corporations with assets in excess of $25 million. (And it should be noted that the remaining amount of ITC credit was calculated upon a flat 10% basis,; the progressive feature of the current proposals would reduce revenue loss even further). Quite obviously, a targeted, progressive ITC of the type described herein could be enacted with a minimum cost to the Treasury. Indeed, the undoubted ability of this more sophisticated mechanism to actually work in promoting investment, employment, and growth would make such limited expenditures highly cost-beneficial and cost-effective.

Actual transformation of the limited, targeted Investment Tax Credit concept into legislative reality may well require further modification and alteration. Additional study, expert evaluation, and business reaction can only imporve upon an already sound beginning. But we strongly believe that the idea itself is one whose time has most definately come.

For further information or assistance contact:

The National Grocers Association
Public Affairs Office
Suite 700
1910 K. Street, N.W.
Washington, D.C. 20006
(202) 955-8400

APPENDIX I

Model One

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $1 million of investment purchases will receive an ITC of 10%.

(3) The second $1 million of investment purchases will receive an ITC of 8%.

(4) The third $1 million of investment purchases will receive an ITC of 6%.

(5) The fourth $1 million of investment purchases will receive an ITC of 4%

(6) The fifth $1 million of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 1,000,000 10%	2,000,000 8%	3,000,000 6%	4,000,000 4%	5,000,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	125,000	0	0	0	0	0	12,500
500,000	250,000	250,000	0	0	0	0	0	25,000
1,000,000	500,000	500,000	0	0	0	0	0	50,000
10,000,000	5,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	0	300,000
100,000,000	50,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	45,000,000	750,000

TAXABLE INCOME	CURRENT LAW TAX	ITC	NET TAX	PROPOSED LAW TAX	ITC	NET TAX	PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	16%
250,000	94,750	12,500	82,250	84,250	12,500	71,750	-13%	2%
500,000	207,750	25,000	164,750	160,000	25,000	155,000	-16%	-5%
1,000,000	439,750	50,000	389,750	360,000	50,000	310,000	-20%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	300,000	3,300,000	-20%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	750,000	35,250,000	-14%	-12%

APPENDIX II

Model Two

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $500,000 of investment purchases will receive an ITC of 10%.

(3) The second $500,000 of investment purchases will receive an ITC of 8%.

(4) The third $500,000 of investment purchases will receive an ITC of 6%.

(5) The fourth $500,000 of investment purchases will receive an ITC of 4%

(6) The fifth $500,000 of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 500,000 10%	1,000,000 8%	1,500,000 6%	2,000,000 4%	2,500,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	125,000	0	0	0	0	0	12,500
500,000	250,000	250,000	0	0	0	0	0	25,000
1,000,000	500,000	500,000	0	0	0	0	0	50,000
10.000,000	5.000,000	500,000	500,000	500,000	500,000	500,000	2,500,000	175,000
100,000,000	50,000,000	500,000	500,000	500,000	500,000	500,000	47,500,000	625,000

TAXABLE INCOME	CURRENT LAW TAX	ITC	NET TAX	PROPOSED LAW TAX	ITC	NET TAX	PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10%
250,000	94,750	12,500	82,250	84,250	12,500	71,750	-13%	2%
500,000	209,750	25,000	184,750	160,000	25,000	155,000	-16%	-3%
1,000,000	439,750	50,000	389,750	360,000	50,000	310,000	-20%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	175,000	3,425,000	-16%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	625,000	35,375,000	-14%	-12%

APPENDIX III

Model Three

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $100,000 of investment purchases will receive an ITC of 10%.

(3) The second $100,000 of investment purchases will receive an ITC of 8%.

(4) The third $100,000 of investment purchases will receive an ITC of 6%.

(5) The fourth $100,000 of investment purchases will receive an ITC of 4%

(6) The fifth $100,000 of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 100,000 10%	200,000 8%	300,000 6%	400,000 4%	500,000 2%	1%	TOTA IT
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	100,000	25,000	0	0	0	0	12,000
500,000	250,000	100,000	100,000	50,000	0	0	0	21,000
1,000,000	500,000	100,000	100,000	100,000	100,000	100,000	0	30,000
10,000,000	5,000,000	100,000	100,000	100,000	100,000	100,000	4,500,000	75,000
100,000,000	50,000,000	100,000	100,000	100,000	100,000	100,000	49,500,000	525,000

TAXABLE INCOME	---CURRENT LAW--- TAX	ITC	NET TAX	---PROPOSED LAW--- TAX	ITC	NET TAX	PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10
250,000	94,750	12,500	82,250	84,250	12,000	72,250	-12%	2
500,000	209,750	25,000	184,750	180,000	21,000	159,000	-14%	-3
1,000,000	439,750	50,000	389,750	360,000	30,000	330,000	-15%	-8
10,000,000	4,600,000	500,000	4,100,000	3,600,000	75,000	3,525,000	-14%	-1
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	525,000	35,475,000	-13%	-1

[2/05/86]

Senator NICKLES. Mr. Box, thank you for your comments.

You spent a lot of time talking about revamping or changing the investment tax credit. I'm kind of like you, I guess, in some respects, of having a small business, but I hadn't thought of that, so I appreciate the suggestion.

You as small businessman, too, might benefit from the reduction—have you looked at the bill from the standpoint of, hey, are the benefits better than the negatives, the good or the bad, say, in your industry?

Mr. Box. In our industry and in most industries, if we considered this from a standpoint of an expansive company, and my particular companies and others like it, it penalizes us if we take away the ITC, and we derive no benefits or relief from FIT, because of our lower taxable income. FIT relief is only given to the large grocery chains with 500,000 or more in taxable income.

Senator NICKLES. OK.

Mr. Box. But it definitely penalizes us. Now, if you are a stable company and do not choose to add the additional capital investment in another business or another town, then it's sort of neutral. But what most of us in the small business end have found, retail grocers, especially, if we're to add another store, we actually need the investment tax credit, because it enables us to basically help justify the cost of the equipment.

Senator NICKLES. Mr. Avants, you mentioned several concerns in a very concise statement, and I appreciate that, retention of interest deductions. You mentioned, also, some concern which I have heard from a lot of people, builders, realtors and others about changing the depreciation time frame. What, it used to be 18 years, now it's 19 years?

Mr. AVANTS. It was 19 years now, and the new law will go to 30 years.

Senator NICKLES. In the House-passed bill it was 30 years; is that correct?

Mr. AVANTS. Yes.

Senator NICKLES. How would you answer if someone came up and said, well, wait a minute, that house is not really depreciating, it's appreciating, and, therefore, a longer period of time would be justified?

Mr. AVANTS. Well, I'd have to answer that, of course, the basis of the computations made for the investment, the initial investment, was dependent upon this depreciation allowance, which once you make the investment, once you make all your projections, then you are tied into a cost, and someone has to make up that cost. If we change that, that means that that cost is not going to be—will not be able to be written off, basically, I guess would be the word. So that the consumer then will have to pay that cost, so we're going to be going back and charging people for higher rents.

Senator NICKLES. Well, you also came and mentioned you wanted to preserve the rehabilitation tax credit, which is presently 25 percent, but you suggested going to 28 percent; is that correct?

Mr. AVANTS. Something like that, yes.

Senator NICKLES. Just more or less along the line——

Mr. AVANTS. One of our really strong needs in all the larger cities is rehabilitation. That helps take care of slums, you know, the whole thing. It's very important to us. As you look around Oklahoma City, you can see a lot of that going on and there was a lot just started recently.

Senator NICKLES. Is a lot of that spurred on for the rehabilitation tax credit?

Mr. AVANTS. Oh, yes.

Senator NICKLES. Without that, do you think a lot of projects would not be done?

Mr. AVANTS. I think a lot of them would die, yes, very definitely.

Senator NICKLES. All right. I appreciate your comment, and to all of our panelists, the weather's bad, and again many of you had to travel for some distance, and we tried to move them up earlier on the schedule so they might be able to get back due to the weather.

I appreciate your interest. I think this has been helpful to me and informative, as well as Senator Boren who is also a member of this committee and other members of the Finance Committee as well as the Small Business Committee and Members of the Senate, this issue of tax reform is now in our plate, I guess, on our agenda, and we're wrestling with the decision whether to move forward or not. As I mentioned earlier, I felt like our primary objective should be deficit reform, and then we should take a look at tax overhaul, I think would be a better term than tax reform.

So we're going to be wrestling with it. Having input from a variety of Oklahomans and Oklahoma firms has been very helpful to me and I appreciate your input. We'll keep the record open for a couple of weeks in case either myself or other members wish to have additional questions submitted to you.

Thank you very much. We'll adjourn the meeting.

[Thereupon, the committee was adjourned at 5 p.m.]

APPENDIX

GBS

General Business Services, Inc.
The GBS Building • 51 Monroe Street • Rockville MD 20850 • (301) 424-1040

February 11, 1986

Honorable Lowell Weicker, Jr.
Chairman
United States Senate
Committee on Small Business
Washington, D. C. 20510

Dear Senator Weicker:

Thank you for allowing me to testify before the Senate Small Business Committee's February 6th hearing on the impact of tax reform and simplification proposals on small business.

As per your February 7, 1986 letter, I am submitting the following additional comments which emphasize the recommendations previously made.

1. The President has asked that the tax reform package be revenue neutral. If a number of suggestions made by the small business community were to be adopted (reestablishment of the investment credit for small businesses), a shortfall will result. I think the small business community would support a supplemental tax such as an energy or consumer tax to make up for the shortfall. The question is, should such a tax be further extended for deficit reduction purposes.

   The small business community perceives that there is a great deal of "fat" and inefficiency in the federal government. They would like to see us hold the line or even cut taxes and thus force the federal bureaucracy to trim unnecessary programs and otherwise become more efficient, the same way that the private sector reacts in times of recession. If they could see cost cutting and efficiency enhancement programs being adopted and continued on a regular basis, I think that they would have no objection to tax increases for deficit reduction purposes.

2. The House tax reform proposal is unacceptable. We would rather see no bill than the House bill. It would, however, be a tragedy to drop tax reform at this time. It is up to the Senate to come up with a workable bill that would take the first step in the direction of true tax reform.

   The House bill carries over dozens of small changes that have very little revenue impact and which are sometimes described as "The Treasury Department Hit List". These changes are submitted under the guise of promoting "equity and fairness," but are really proposals aimed at making the policeman's job easier without much thought for the citizenry. These proposals are given to us by the same parties who recommended the "auto log". These changes include "eliminating scholarship and fellowship exclusions," "repealing exclusions for prizes and awards," "repealing political contributions credit, etc." and dozens and dozens of others.

The House bill is so long and complex that none of these miscellaneous provisions have received a fair hearing, nor could the Senate consider them all at this time. The Senate should eliminate most of these provisions and come up with a bill that addresses itself to the key "money" issues postponing these other changes for later consideration in a more orderly fashion.

3. The following key small business issues should be considered for inclusion in the new Senate bill:

   a. Graduated tax rates are necessary for the tax bill to be truly revenue neutral for small corporations. The House bill doesn't fully accomplish this objective and the scope of the brackets should be further studied by the Senate to ensure fairness.

   b. Except for the original "jobs tax credit," no provision in the tax law has had more positive impact on helping promote the growth of newly established small businesses than the investment credit; it should be retained for small businesses.

   c. Requiring small businesses to use an accrual method of accounting can seriously inhibit their growth, especially in their "embryo" stage. The existing rules concerning the use of the cash method of accounting should be retained for businesses with less than five million dollars of gross receipts, regardless of the accounting method they use in preparing financial statements. In addition, businesses with less than half a million dollars in gross receipts (small sole proprietors, etc.) should be allowed to use a cash method even though they have inventories.

   d. Statistics show that a far smaller proportion of small businesses than big businesses provide health, medical and retirement plans for their employees. There are a number of reasons for this, one of which is the ever-growing complexity of compliance rules and discouraging "paperwork" requirements, etc. Big business can afford the actuaries and legal fees needed to comply with constantly changing compliance requirements; small businesses cannot. It is in the public interest to have this type of protection provided by the private sector, rather than the government. Keeping the rules as simple as possible is critical for small business participation.

Sincerely yours,

Jim McCarthy

James D. McCarthy
Executive Vice President

JDM:bam

COMMITTEE ON SMALL BUSINESS
HEARING ON THE LIABILITY CRISIS AND HOW IT AFFECTS SMALL BUSINESS

FEBRUARY 20, 1986

STATEMENT:

The Diving Equipment Manufacturers Association, representing every major domestic manufacturer of recreational diving equipment, is very concerned about the seriousness of this Nation's liability dilemna. Our industry, comprising of thousands of small businesses and directly employing more than thirty thousand people, has been adversely affected to the extent many small businesses will fail to survive this crisis.

In a recent survey (where fifty percent of our members responded), we were appalled to learn that forty percent of the respondents were uninsured. Not by choice, but because of either extremely inflated and unaffordable premiums, or the unavailability of products liability insurance at any price. Those members able to purchase insurance were, in many instances, forced to pay premiums which had increased as much as five hundred percent, with half the coverage and increased deductibles.

The thousands of dive store retailers who market the products we produce found their liability premiums doubled and tripled this past year, when they could obtain coverage.

All of these increases appear to be capricious and unwarranted, particularly for an industry whose record continues to improve every year.

The threat to our Country's economic system and the stability of its small business community is without precedent. We believe Government must act now to stop this uncontrolled and chaotic rush into economic catastrophe.

We have all heard the "reasons" for the liability crisis. The American Trial Lawyers Association is meeting in California in two days. Before kicking off their program, they will hold a reception to honor those judges, reporters and consumer groups who have advanced injured victims' rights against manufacturers and others.

This Committee must move for immediate tort reform which will set reasonable limits on injury and fatablity awards.

This Committee must ask for governmental investigation into and immediate regulation of the insurance industry. Liability insurance must be available to all Americans at a rate commensurate with risk.

This Committee should decry and move for an end to the practice of "redlining" an entire industry Insurers must insure against risk...not bet on a sure thing...

We applaud this Committee's efforts to resolve the liability crisis and stand ready to support you in your efforts.

Robert Gray

ROBERT L. GRAY
Executive Director
Diving Equipment Manufacturers Association

STATEMENT ON
TAX REFORM AND CAPITAL FORMATION

submitted by

National Society
of Public Accountants

The National Society of Public Accountants (NSPA) is pleased to submit this statement on the topic of Tax Reform and Capital Formation for the Senate Small Business Committee hearing of February 6, 1986.

NSPA is a professional society representing over 17,000 practicing accountants located throughout the United States. The National Society also has an affiliated state organization in each of the 50 states, the District of Columbia and the Commonwealth of Puerto Rico.

The members of the National Society are, for the most part, sole or partners in moderately sized public accounting firms. NSPA members provide accounting, auditing, tax preparation, tax planning and management advisory services to more than 4 million individuals and small businesses. Members of NSPA are pledged to a strict code of professional ethics and rules of professional conduct.

The small business clients of our members have found it very difficult to implement a proper business plan given the major tax law changes that have occurred in the last several years. Since 1981, there have been three major tax bills enacted into law. Due to the Tax Reform Act of 1985

(H.R. 3838), as passed by the U.S. Representatives, the business community and individuals face an even more dramatic and substantive change in the tax laws. In specific, H.R. 3838 makes such monumental changes in the tax law that the Ways and Means Committee has deemed it necessary to rename the Tax Code as the Internal Revenue Code of 1985.

Public accountants appreciate the difficulty that frequent changes in the tax law can have on the ability of a small business person to implement a proper business plan. In this context, during the past few years we have testified before the Treasury Department and Congressional Committees and urged the establishment of a National Commission on Reform of the Income Tax System. The Commission would study and review the current Income Tax System to help Congress formulate a proposal for true tax reform. Further, we had asked for a moratorium on the enactment of any income tax law during a five-year period. This latter recommendation is a recognition of the negative impact that frequent changes in the tax law have on the business plans of entrepreneurs.

Tax Reform Act of 1985 (H.R. 3838)

Although we would prefer the establishment of a Commission on tax reform, we realize that H.R. 3878 has a reasonable chance of passage and thus, we would like to provide our comments on specific provisions of the legislation in order to help Congress formulate a more balanced package. In addition, we would like to make two specific recommendations on provisions that merit the Committee's consideration on tax reform, although such proposals are not included in H.R. 3838.

Cost Recovery Provisions

Section 201 of the H.R. 3838 provides for the repeal of the Accelerated Cost Recovery System (ACRS) and its replacement with the Incentive Depreciation System (IDS) for tangible property. NSPA supports the House Ways and Means Committee's approach regarding capital cost recovery.

When ACRS was enacted into law in 1981, it was based upon a recognition that the rate of productivity for U.S. manufacturing industry was dropping and as a result, the nation's business community was losing ground economically to our major trading partners. The so-called 10-5-3 depreciation proposal garnered tremendous support in Congress, the Reagan Administration, and in many sectors of industry as a way in which to encourage investment in new production facilities. However, ACRS was not supported broadly by the small business, high technology or service sectors of the economy. Ironically, these particular industrial sectors are the very segments of the economy which have created the predominance of the jobs for the American workforce.

By permitting taxpayers to depreciate personal property over 3-year, 5-year, 10-year or 15 year recovery periods (or 19 years for real property placed in service after May 8, 1985), the Tax Code permits taxpayers to depreciate equipment or buildings in a significantly shorter period of time than the true economic or useful life of the property.

Through the repeal of ACRS, the Ways and Means Committee is developing a more equitable system of business taxation. In the context of the Administration's proposal for lower marginal rates, NSPA believes that there is no need for a depreciation system which provides taxpayers an economic benefit far in excess of that which would be available under generally accepted accounting principles. Moreover, NSPA considers the repeal of ACRS, and its replacement with an Incentive Depreciation System (IDS) as an appropriate avenue through which to raise the necessary revenues to fund the reduction in marginal tax rates.

Investment Tax Credit

Whereas, ACRS might not be a necesssary component of the capital formation process for small business, the investment tax credit (ITC) is. The ITC provides small firms with a meaningful increase in its cash flow in the year in which it makes a capital investment. Accordingly, NSPA favors the retention of the investment tax credit as a component of the capital formation process for the U.S. economy. Nevertheless, due to the importance of revenue neutrality, the National Society would support a $75,000 limit on the amount of investment tax credit that a taxpayer may take on its tax return for any one taxable year.

Corporate Tax Rates

H.R. 3838 provides for a reduction in the marginal tax rates for corporations as well as individuals. The legislation accomplishes this objective, in part, by reducing the top corporate rate from 46 percent to 36 percent. In specific, the Ways and Means Committee Report on the Tax Reform Act of 1985 (dated December 7, 1985), states in pertinent part as follows:

> "One of the most important objectives of the bill is to reduce marginal tax rates on income earned by individuals and businesses. Lower tax rates promote economic growth by increasing the rate of return on investment. Lower tax rates also improve the allocation of resources within the economy by reducing the impact of tax considerations on the choice between

> alternative investments. In addition, lower tax rates promote compliance by reducing the potential gain fron engaging in transactions designed to avoid or evade income tax."

NSPA is fully supportive of the proposal to reduce the top corporate rate to 36 percent, as well as the recognition by the Ways and Means Committee of the need to retain the graduated rates for small corporations. The Committee Report on H.R. 3838 states that "the present law graduated rates for lower income corporations are intended to encourage growth in small business by easing the tax burden on such businesses."

Although the Ways and Means Committee is generally supportive of graduated corporate tax rates, as provided for in H.R. 3838, NSPA is opposed to the proposal in the bill to phase out the graduated rates beginning at the level of $100,000 of taxable income.

As part of the need to increase federal revenues, the Deficit Reduction Act of 1984 (DEFRA) includes a provision which phases out the graduated rates for large corporatons. DEFRA phases out the benefits of the graduated rates for corporations with taxable income in excess of $1 million, by imposing an additional 5 percent tax (which is in addition to the regular 46 percent tax rate of current law) on the next $405,000 of taxable income.

Due to the current budget deficits and the need to attain a tax reform bill which is revenue neutral, NSPA recognizes that there may be a legitimate policy need for recapturing the benefit of the graduated rates at some threshold level. Nevertheless, the National Society believes that the threshold level for recapture should be significantly higher than the starting level (as under the bill) of $100,000.

Under the Tax Reform Act of 1985, due to the graduated rate schedule, a corporation would pay $22,750 in taxes on its first $100,000 of taxable income for an effective tax rate of 22.75 percent. The Ways and Means proposal would start recapturing the benefit of the graduated corporate rates by imposing the additional 5 percent surtax on corporations with $100,000 of taxable income or more. Until the point that the full benefit of the graduated corporate rates is recaptured, the effect of the recapture proposal is to impose a 41 percent marginal tax rate on each dollar of corporate taxable income in excess of $100,000.

Faced with a 41 percent marginal tax rate on taxable income between the levels of $100,000 and $365,000, corporations of that size level receive proportionately less of a tax benefit from the rate reductions than their larger corporation counterparts which are subject to a flat 36 percent corporate tax rate under the legislation, once the corporation has taxable income in excess of $365,000.

As a matter of tax equity, NSPA urges the Congress to consider raising the threshold for recapturing the benefit of the graduated rates to a level significantly higher than $100,000 of taxable income.

Alternative Minimum Tax

The Ways and Means Committee Report on H.R. 3838 states that the overriding objective for a minimum tax is "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." "The ability of high-income taxpayers to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves."

NSPA appreciates the Congressional Tax Writing Committee's concerns in this area. Nevertheless, the National Society believes that by setting the alternative minimum tax at a rate higher than the maximum effective tax rate for net long term capital gains for individuals (as H.R. 3838 does) this creates an inadvertent trap for the unwary. It is possible in an alternative minimum tax situation, under H.R. 3838, for LTCGs to be taxed at 25% rather than 22% as the Congress apparently wanted. Thus, we would suggest that the alternative minimum tax rate be no greater than the maximum effective tax rate for long-term capital gains.

Limitations on Deductions for Meals, Travel and Entertainment

Section 142 of H.R. 3838 provides for certain limitations on deductions for meals, travel and entertainment. In specific, this section provides that no deduction shall be allowed for the expense of any food or beverage unless:

"(1) the furnishing of such food or beverages has a clear business purpose presently related to the active conduct of a trade or business,

"(2) such expense is not lavish or extravagant under the circumstances, and

"(3) the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages."

The bill places a further restriction on such expenses by limiting the allowable deduction on business meals and entertainment to 80 percent of the amount of the expense. NSPA is deeply concerned over this provision. The House of Representatives passed this provision because it felt that there was an abuse from "excess personal consumption."

By limiting business meal and entertainment deductions to 80 percent of the amount of the expense, NSPA believes that the proposed limitation will do little to restrict the personal consumption element of meal and entertainment expenditures. The National Society considers the limitation to be arbitrarily conceived and extremely subjective in design. Section 142 of H.R. 3838 will result in a compliance nightmare for taxpayers, resulting in an increase in IRS audits.

At-Risk Rules

The current tax law permits individuals and certain corporations to deduct losses from real estate which are in excess of the amount that they have "at risk." Except for certain transactions involving unrelated third-party nonrecourse debt, H.R. 3838 extends the scope of the "at-risk rules" to real estate. NSPA is opposed to this new limitation. Many small businesses are required to give or take seller financing. Thus, the limitation could result in a severe downturn in what may otherwise be productive investment by small business, such as investment in plant and equipment.

Cash or Deferred Arrangements (CODAs)

Given the increasing proportion of senior citizens and retired individuals in the U.S. population, there is an ever increasing need for a viable national retirement income policy. This national policy should strive for a secure private pension system designed to supplement the Social Security system.

NSPA believes that the pension provisions of H.R. 3838 move away from these objectives. The National Society is particularly concerned about the linkage of the IRA contributions with the $7,000 limitation on the amount that employees can defer yearly under qualified cash or deferred arrangements (the so-called 401(k) plans). More specifically, NSPA believes that there should be no linkage between the two retirement programs.

Qualified cash or deferrred arrangements have become increasingly attractive to rank and file employees of companies which offer such plans. Under the special nondiscrimination tests of current law, a company cannot offer a 401(k) plan to its employees where the plan disproportionately benefits highly compensated employees at the expense of rank and file workers. NSPA believes that the nondiscrimination requirements of current law have worked well in accomplishing the objective of assuring relative equity of financial benefits for employees of all income levels.

To the extent Congress and the Administration consider it necessary for budgetary reasons to place further restrictions on 401(k) plans, then the placement of a $7,000 limitation on the amount that employees can contribute yearly to a 401(k) plan may have merit for policy reasons. NSPA understands and would accept such a policy position. However, by linking the contribution limit for IRAs to the proposed $7,000 limit on 401(k) plans, H.R. 3838 adds a layer of complexity to two fundamentally independent national retirement programs.

The major appeal of individual retirement accounts to taxpayers has been the freedom of investment opportunity, as well as the simplicity of the retirement plan itself. By linking IRA contributions with 401(k) plans, taxpayers will be hindered by severe tax compliance problems. In addition to raising major recordkeeping problems for taxpayers and their employers, the linkage causes compliance problems for banks, securities firms, insurance companies and other financial institutions as well. NSPA is concerned that the cost of the recordkeeping burden will ultimately fall on the individual taxpayer.

The Practice Before the Tax Court of Enrolled Agents and CPAs

NSPA is fully supportive of section 1546 of the Tax Reform Act of 1985. As approved by the U.S. House of Representatives, this provision would permit enrolled agents and CPAs to

represent taxpayers before the Small Tax Case Division of the Tax Court, with respect to disputes with the IRS of $10,000 or less. Trials of such cases are normally conducted informally and generally do not require the filing of briefs.
To the extent a taxpayer obtains outside assistance to prepare his income tax returns, he will very often utilize a CPA or enrolled agent. Thus, it is the CPA or enrolled agent which will likely be the most knowledgable about the particulars of the taxpayer's return. In a small dispute (such as ones involving amounts under $10,000) with the IRS, it would be very costly for the taxpayer to hire an attorney, who must then be paid to learn the case from scratch.

By permitting taxpayers to be represented in Tax Court by the professionals who filled out their return originally, this would greatly expedite the docket of small cases before the Tax Court. Thus, taxpayers would obtain effective professional representation before the Tax Court at a reasonable cost. In specific, this proposal would greatly simplify and expedite the resolution of taxpayer claims.

The Deposit Rules for Payroll Taxes

One of the major problems facing small business today involves payroll tax compliance. Since small businesses are often more labor intensive than their larger business counterparts, payroll taxes can impose a higher burden of compliance on smaller firms than other section of the tax law. The current law and regulations generally require a business to make payroll tax deposits with the IRS as often as it pays its employees, which may in many cases be four times a month. In the context of tax reform, NSPA urges that Congress give serious consideration to implementing procedures which lessen the payroll tax deposit and recordkeeping burdens facing small firms. One means of accomplishing this objective would be to permit a business with Federal payroll tax deposits of $5,000 or less to make such deposits on a once-a-month basis with a Federal depository (i.e., an institution which collects payroll tax deposits on behalf of the IRS).

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) is designed to ensure that Federal agencies take into consideration the impact of their regulatory actions on small business. Before promulgating a regulation, RFA requires a federal agency to conduct an impact analysis as to the relative burden of that regulaton on small business.

Since its enactment, the IRS has considered itself exempt from the provisions of the Act. Accordingly, NSPA suggests that Congress extend the RFA to all IRS and Treasury Department rulemaking, including interpretative rules.

Statement by the

NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

concerning the

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

The following statement is submitted by the National Association of Professional Insurance Agents (PIA) for inclusion in the hearing record of the Senate Small Business Committee for the February 6, 1986 hearing on the impact of tax reform and simplification proposals on small business.

PIA is a national trade association representing more than 40,000 independent insurance agents who sell and service property and casualty insurance. Our members are primarily the principals of insurance agencies that represent several insurance companies. These agencies typically employ an average staff of five persons. PIA has 40 state/regional affiliates around the nation.

PIA has followed with considerable interest the evolution of the tax reform proposal that is now before the Senate. While the House-passed tax bill, H.R.3838, contains several provisions affecting small business, our comments will be centered on proposed changes in employee benefits and changes in retirement plans.

INTRODUCTION

Our Nation has successfully provided health care, education, retirement security and life, disability and unemployment insurance to our citizens through the private sector. Other industrialized nations have chosen to use costly, government-financed programs to meet the needs of working men and women -- needs which we have met through tax code incentives.

For almost a half century, Congress has encouraged American business and labor to create and maintain employee benefit programs for the security of employees and their dependents. A key element in providing support for these private sector efforts has been the tax treatment afforded certain benefits under current law. This tax treatment has produced impressive results at a minimum cost to the government.

STABILITY OF THE TAX SYSTEM

PIA is seriously concerned that the sheer quantity of legislative changes that have been made in recent years is having a significant adverse impact on the private employee benefit system. Every round of revisions necessitates burdensome amendments, at considerable cost, to existing plans. While one set of change is burdensome enough, in the aggregate, the drain of continual Congressionally-mandated alterations is enormous.

PIA member-agencies have a great deal of difficulty keeping up with the changes in the tax law that are being enacted practically every year. In 1984, the employee benefits area was revamped, and now it is being considered again in the context of tax reform.

Typically, our insurance agencies must rely on outside counsel to keep abreast of tax changes and to develop prudent financial strategies within the framework of changes in the code. Valuable resources in terms of time and money must be expended in response to the continually changing tax environment at a time when most businesses need to direct their resources internally in order to ensure their operating success.

Employee benefits should be left intact at this time, as the burden for most small businesses is too great when they repeatedly have to hire professionals to make sure their plans qualify under the changing rules.

ADVERSE CONSEQUENCES ON EMPLOYERS AND EMPLOYEES

PIA is concerned about the adverse consequences the Adminstration's proposals to revise the treatment of employee benefits will have on both employers and employees.

Proposals which would tax employer-provided benefits will strike hardest at those with the costliest health premiums, the chronically ill, the disabled, and families with children. In addition, changes to current tax policies would be disastrous to the financial security of those who have worked the longest and are nearing retirement age. Surveys of businesses show that employers may increase premiums or cut back coverage if benefits are taxed. The result will be higher costs for the Federal Government as affected workers are forced to turn to Medicare and Medicaid.

A survey of PIA membership showed that most of our members would be affected by the proposed taxation of employee benefits. Many independent insurance agents would face a double-barreled problem because they wear two hats -- they are both an employer as owner of their agency, and an employee of the agency as chief executive officer. The average age of a PIA member is 47.

H.R.3838, as passed by the House or Representatives, will not tax employer-provided benefits. However, the door to such taxation remains open especially at a time when Congress focuses on the federal budget deficit.

TAXATION OF HEALTH BENEFITS

PIA has voiced its opposition ever since the idea of a health tax was conceived. We feel this particular proposal is poor policy

-- either as a health cost containment measure or as a federal revenue raiser.

We support the need to balance the federal budget. However, the proposed tax revision would be especially hard on small businessowners, the segment of the business community our membership represents.

The advent of group health policy purchase for the small businessowner was a great assistance. Insurance agency principals could offer comparable health benefit packages, like those offered by larger employers, and absorb the total cost. This improved the competitiveness of the small businessowner. However, with the present economic status of our industry, our members have been faced with decreasing commissions and increasing expenses. This has resulted in lowered agency income and extreme prudence in the salaries offered to employees, owners included.

Additionally, the skyrocketing cost of health care has forced many of our members - for the first time - to require their employees to share in the premium payments for group benefit programs. If we add to this the cost of employee health benefits as taxable income, the negative result would be twofold: employees would ask for an increase in salary and/or seek an employer who pays full benefits in order to offset the higher tax/cost burden. This threatens the quality of employee available to our members and the stability of the employee rate of turnover. As insurance agents, we have prided ourselves on being able - in most cases - to offer a better-than-average health benefit program. Any tax proposal will have an effect on the type of benefit program we can offer our employees.

PIA believes taxing employer-provided health insurance is fundamentally unsound whether the tax is in the form of a floor, cap or in some other form.

The health tax cap approach would cause serious consequences for certain groups of employees. Older workers generally have a greater need for health care services. This cap would tend to induce younger, healthy workers to either drop health coverage or limit it to the amount that could be obtained within the cap to avoid a tax increase. Older workers, the additional taxes withstanding, would continue to demand full coverage for obvious reasons. This result would be a classic case of what the insurance industry calls "adverse selection." The aggregate group premium base would be reduced by the response of younger workers, leaving older employees and their employers to face higher health coverage costs. Workers engaged in hazardous occupations would also be placed in an adverse selection situation by the cap.

The "floor" approach to a health tax would impose a tax burden on all working individuals and families that receive employer-provided health care benefits. Its impact would fall on low income familes that could least afford this new tax burden as a percentage of disposable income. It lacks any incentive for employers to efficiently provide and for employees to efficiently utilize, health care benefits options.

MODIFICATIONS TO RETIREMENT SAVINGS PLANS

The House tax bill may alter the status of many retirement savings plans.

The proposal to restrict employee use of 401(k) savings and retirement plans would be a serious blow to the small businesses that form the backbone of America's economy. Our economy relies on small businesses such as independent insurance agencies. The proposal would undercut savings and retirement plans that are prime vehicles for strengthening these businesses in a highly competitive economy.

H.R.3838 would limit contributions to 401(k) plans to $7,000 per year. Any contributions to these 401(k) plans would reduce the amount that could be contributed to an Individual Retirement Account (IRA). We believe that this is a serious mistake. Our country has a very low rate of savings, and 401(k) plans have become increasingly popular. Small businesses have difficulty attracting qualified employees, because the large companies with whom they are competing for good employees often can offer better benefits. The limitation on the 401(k) plans is just one more impediment for small businesses in their attempt to maintain an experienced, well-qualified work force.

401(k) plans are a vital instrument for ensuring retirement income security. Social Security and even private pension plans, where available, cannot always do the job in providing sufficient income.

PIA has a 401(k) plan available to its employees, its affiliate associations and their employees, and to its member-agents and their employees. The plan offers them flexibility for the limited discretionary income they can invest for long-term goals such as retirement.

The Tax Reform Act of 1985 (H.R.3838) now before you for consideration contains a discriminatory proposal against tax-exempt groups like PIA. As passed by the House, only those tax-exempt groups that have applied for an Internal Revenue Service (IRS) letter of determination by November 6, 1985, would be "grandfathered in" among the groups eligible to maintain 401(k) plans.

PIA believes the creation of this entirely new and arbitrary requirement establishes a standard which discriminates against all tax-exempt groups by allowing only some groups to maintain 401(k) plans and blocking any future 401(k) plans for tax-exempts.

There is no legal mandate requiring a 401(k) plan to receive an IRS determination letter; so the status of one's plan should not be based on application for such a letter. Using this retroactive "grandfather date" will deny savings for employees whose plans had been established but for which no IRS letter had yet been sought. And, of course, it denies tax-exempt groups that had not yet even established these valuable plans.

Tax reform is supposed to advance fairness in the tax code. Treating employees of tax-exempt organizations differently from other employees is contrary to that goal. 401(k) plans should be preserved for all organizations and should remain structured to allow widespread participation.

CONCLUSION

We recognize the Congress' task in developing a tax reform bill is not an easy one. We do not take our positions lightly, and are firmly convinced that taxing employee benefits is not in the best interest of employees, their families and the country. Our current system of encouraging employer-provided coverages has worked remarkedly well. Coverage is widespread; it is provided through an efficient, effective, flexible group mechanism; and it has relieved government of the responsibility.

The specific proposals advanced by the Administration are inconsistent with our country's long-established policy favoring employee benefits, and we urge your Committee to reject them. To impose any tax on employee benefits would establish a bad precedent and could signal to employers and employees that the proposed taxes are only the first step.

PIA urges Congress to continue the present system of tax incentives so that our employee benefit programs remain intact.

Thank you for this opportunity to present our views on some of the provisions that are being considered in the tax reform debate that are of particular importance to PIA members.

* * *

FREDERICK F. DRUMMOND TELEPHONE 918-287-2116
RANCHING P. O. BOX 1868
PAWHUSKA, OKLA. 74056

February 10, 1986

Tracy Crowley,
Hearing C~~lerk~~
Senate Committee on Small Businesss
Room 428-A, Bussell Senate Ofc Bldg.
Washington, D.C. 20510

Dear M/S Crowley:

This letter is in response to my inability to attend the Senate Small Business hearing in Oklahoma City this afternoon. There was a snow storm which made the roads inpassable.

My comments are few, however, the impact of the bill seems to be one of additional complication ,.not simplification.

The Capital Gain rate was raised from 20 to 22%. In many cases where Farmers or Ranchers are forced to sell their properties due to the extremely difficult economic situation, and where there might be a low basis in the property as it could have been in the family for generations; the rate is already confiscatory and this would be worse. They are already broke, so on top of that you now have a new tax lien that rubs salt into an already unsavory wound.

We need to keep funds available for investment and capital formation. Preservation of the cash basis of accounting is imperative. Without these options of the cash basis, operators would be unable to take advantage of market flucturations. Tightening up on "At Risk" investments will not work a great hardship, but to make farmers and ranchers acrue all their purchases and inventory would make things impossible.

A good example is the new simplification of proving that business vehicles are really for business. Once the IRS tehhnicians had finished with that , it is as complicated and unwieldly as it initially was, hence congress was totally sidetracked by those people.

I strongly urge you to keep it simple and not make it a revenue raising bill which they usually turn out to be.

Respectfully submitted,

Frederick Drummond
President, Oklahoma Cattlemens Assn

Statement of
The Associated General Contractors of America
Presented to the
Committee on Small Business
United States Senate
February 20, 1986
On the Topic of
Tax Reform and Small Business

AGC is:

- More than 30,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
- 110 chapters nationwide;

AGC members complete:

- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
- Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) represents more than 32,000 firms, including 8,400 of America's leading general contracting companies. These member firms perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. More than 90 percent of AGC's member companies are small businesses, as defined by the small business administration's size standards. We appreciate the opportunity to submit a statement on the topic of comprehensive tax reform as it impacts small construction firms.

The construction industry is truly one of the last bastions of unfettered free enterprise, and as such, is a national haven for small businesses. This industry is typified by family-owned businesses which jealously guard their integrity and reputation in the community, in an extremely open and competitive industry. Construction is not dominated by a few firms, rather it is dominated by the open competitive bid system. That is, competition in terms of price and ability to complete the task determines which companies win contracts.

AGC's statement addresses and opposes tax reform provisions which will affect the use of the completed contract method of accounting in the construction industry. Without reservation, and uniformly throughout the industry, we oppose those provisions.

We will also discuss the industry's concerns regarding other provisions of proposed comprehensive tax reform. AGC has taken great care to analyze the impact of these other proposed changes on both our industry and the U.S. economy as a whole. We have concluded that the proposed changes would adversely impact the construction industry and capital formation, and therefore we oppose the comprehensive tax reform legislation passed by the House of Representatives, H.R. 3838.

The relationship between a sound and healthy construction industry and a sound and healthy economy demands a thorough analysis. Consider these facts:

o The $348 billion construction industry is the largest goods-producing industry in the country. Whether measuring employment, the value of goods produced (shipments for manufacturing or construction put in place), or what the industry contributes to the gross national product, construction comes out ahead of autos, steel, or any other manufacturing industry.

o The construction industry employed 4.3 million workers in 1984 and the number of workers on industry payrolls has continued to grow, reaching 4.8 million by December of 1985. In 1984 construction employers provided 4.6 percent of the jobs in the U.S. economy.

Another 4.5 percent can be attributed to supplier industry jobs, with an additional 7.8 percent induced in other sectors by the ripple effect of construction activity.

- Construction is an unusually productive industry; because dollars invested in construction are spent on wages, supplies, and materials used in construction. Additional economic growth is created by each $1 spent on construction.

- Although estimates of the economic growth created vary according to the method used to construct the multiplier, each $1 invested in construction adds $2.23 worth of economic transactions to the economy, incorporating payments to suppliers and their payments to other industries, and so on. An estimate of federal construction spending concluded that each $1 invested in the nation's infrastructure added $2.35 to the economy. Over time, each $1 may be responsible for adding as much as $2.80 to the nation's economic potential.

- Over 61 percent of the inputs to the construction process are purchases from other industries while another 30 percent is labor services. Construction, while constituting 8.5 percent of the gross national product on its own, also supports many supplier industries. As much as 14 percent of the gross national product may depend directly or indirectly on construction.

It is a certainty that changes that adversely impact the construction industry will surge throughout the entire economy.

A significant adverse impact on individual construction firms will result from provisions which will severely limit the use of the completed contract method of accounting in the construction industry.

The Completed Contract Method of Accounting

Background

At the outset, we must emphasize that the construction industry is not the source of any problems with the completed contract method of accounting. It was used by and widely accepted for the unique nature of the construction industry as the appropriate financial accounting method even before the enactment of the income tax.

We must be equally emphatic that elimination of the completed contract method of accounting for the construction industry will quickly bankrupt thousands of construction firms and will also have a devastating impact on competition in our industry.

The completed contract method of accounting is a method of reporting income (gain or loss) for tax purposes from long-term contracts. It was first included in Treasury Department regulations in 1918 as the appropriate accounting method for construction contractors following the enactment of the modern business income tax in 1916.

The completed contract method requires a contractor to wait until a contract is finally completed and accepted before reporting a gain or loss from the contract for income tax purposes. The method is the most accurate method for determining gain or loss on construction contracts. The method meets the requirements of the "all events test" for determining income due to the inherent risks and the unique nature of the construction industry. The all events test requires that a taxpayer perform all responsibilities necessary to earn income or realize a loss before it can be declared a gain or loss. The completed contract method mirrors this requirement by recognizing the fact that until a project is completed and accepted by the owner the contractor has no certain claim to either a gain or loss from the contract.

From 1918 to 1976 the completed contract method was limited to construction, building and installation contracts. These are the traditional types of contracts found in the construction industry where the taxpayer builds a single project. They include all forms of contracts for the construction of industrial, highway, and single structures and the various subcontracts required in the construction of the projects.

During the 1960's a variety of other types of contracts attempted to qualify for the completed contract method by judicial interpretation under one of the three traditional categories of long-term contracts. Following this litigation the Treasury Department fully revised the regulations concerning the eligibility and use of the completed contract method of accounting in 1976. A new category of long-term manufacturing contracts was added to the eligibility list for completed contract reporting. As a result of the 1976 regulations, groups now using the completed contract method include construction, shipbuilding, aerospace, weapons manufacturers, heavy equipment manufacturers and a variety of other manufacturers.

The completed contract method has been the appropriate method of reporting income from construction contracts for the last 69 years because of the unique nature and inherent risks of the construction industry. These risks and the unique nature of construction do not permit a contractor to realize any gain or loss from his performance of a contract until it is completed. Only after a contractor performs all his contractual responsibilities can he determine a gain or loss.

The unique nature of construction and the inherent risks of construction are as great and significant today as they were 69 years ago. These factors unique to construction include:

- differing sites for each project with varying soil conditions

- varying and unpredictable climate and weather conditions

- firm prices for the duration of a contract which require the contractor to bind himself to a price before actual costs are known

- owner retention policies under which owners typically retain a percentage of the contract cost from progress payments until all work is complete and accepted

- changes, modifications or claims during the course of the contract which require the contractor to spend large sums in advance of this contractual right to fully collect contract revenues from the owner

- intense competition within the industry, resulting in exceedingly small profit margins, both in relation to total receipts and in comparison with other industries. One study by a nationally-known consulting firm calculated the net operating margin for 62 general, heavy, industrial, and process plant construction firms at 1.6 percent (most recent fiscal year).

These risks are not found in other industry users of the method. These variables necessitate that profit on a construction contract be reported only after contract completion and acceptance, when gain or loss is known and certain.

Retention

Virtually all construction contracts have retainage provisions where the owner retains part of his payments until contract completion. In some instances the retainage arises through a contractual provision for progress billing, in others there is a specific retainage of a percentage of the portion of the contract price. Retainage in most cases is equal to or exceeds the total profit from the contract.

Retainages are also often used for corrections or defects after project completion. In all cases, retainage is not released to the contractor until after project completion. Consequently, the profit element of a construction contract is not received until retainage is released.

Recent Regulatory and Legislative History

The completed contract method of accounting as currently used is the result of a five-year dialogue between the industry and the Treasury, commencing with proposed regulations in 1971. After two revisions, final regulations were published by the IRS in 1976 providing specific administrative rules for taxpayers electing the method.

Under the regulations, all direct material and labor costs are allocated to the long-term contract and therefore are not expensed immediately, but only deducted at contract completion. In addition, 28 categories of indirect costs were specified. Under current regulations for long-term contracts 15 of these cost categories are allocated to the specific contract and deducted at contract completion.

Thirteen cost factors were thought to be appropriate current business operations expenses which should correctly be deducted in the year in which they are incurred rather than allocated to a contract. These costs, known as period expenses, include items such as general and administrative expenses, marketing, selling and bidding expenses, and interest. For example, janitorial expenses at a home office are not a cost which can be logically allocated to a specific contract in any administrable manner since it is a necessary cost for all of the business operations of the contractor.

The 1976 rules are still used by virtually all construction contractors and were approved legislatively in the Tax Equity and Fiscal responsibility Act of 1982 (TEFRA). The 1976 rules reflected the 58 years of experience accumulated by the IRS in administering completed contract reporting by the construction industry and are regarded as fair by the industry for reporting income. They are based on traditional accounting principles and reflect basic tax policies of the Code.

As a result of the 1976 regulations, certain long-term manufacturing contracts could elect to use the accounting method for the first time. Prior to 1976 only taxpayers performing construction, building and installation contracts could use the completed contract method for income tax purposes. After several years the Treasury Department identified a variety of abuses of the method as it was being applied in the manufacturing industries.

For example, certain contract completion dates were being extended by contract duties which were merely incidental responsibilities. Contracts were being extended past their natural completion dates by increases in the number of units to be delivered under the original contract, such as adding-on to the number of planes or missiles being built. Abuses of this sort simply cannot occur in the construction industry, but did appear in some manufacturing industries.

The Treasury also asserted that the cost allocation rules (used to measure gain or loss) did not match items of income and expense accurately. This assertion was made primarily because of exceptional duration manufacturing contracts of 10-20 years which are not found in the construction industry.

As a result of some of these problems, in 1982 the Treasury Department proposed replacing the completed contract method of accounting with a new method of accounting known as the progress payments method. The Treasury also proposed an alternative option of changing the cost allocation rules, contract completion rules, and rules for severing and aggregating contracts. The Treasury dropped its progress payment method of accounting proposal during the legislative hearings preceding the enactment of TEFRA after the construction industry identified numerous flaws in the proposal.

Congress then dismissed many of the theoretical positions in the Treasury's alternative recommendations as being inconsequential as they would apply to the construction industry and directed that none of the new cost allocation rules in TEFRA for extended-period long-term contracts be applied to construction contracts lasting less than 36 months or to any construction contractor with less than $25 million in annual gross receipts.

Congressional action in 1982 was a direct result of the recognition that fundamental differences exist between the diverse industries now being allowed to use the completed contract method. Congress chose to require these revised cost accounting rules for extended period long-term contracts be applied to all manufacturing contracts lasting longer than 24 months, regardless of the manufacturer's size. The other aspects of the TEFRA completed contract provisions (new contract completion, severing and aggregating rules) did not apply to construction, as the industry pointed out, and no specific exceptions were necessary.

The Administration's recognition of the importance of the traditional use of the completed contract method of accounting in the construction industry went even further than the action taken by Congress in 1982. Following the tax committee mark-up of TEFRA in the Senate Finance Committee, then Secretary of the Treasury Donald T. Regan wrote to the TEFRA Conference Committee Chairman Robert J. Dole that "After further consideration I am concerned that the Senate provision dealing with the completed contract method of accounting is perceived to have an unnecessarily adverse impact upon the construction industry at this time". If Secretary Regan's recommendation had been acted on there would have been no change at all in the construction industry's use of the completed contract method of accounting.

Current Proposals

The House of Representatives and the Administration have recommended different proposals affecting the use of the completed contract method of accounting. Each of these proposals was reviewed and rejected by Congress in 1982. The House of Representatives' proposal (included in H.R. 3838) would repeal the completed contract method of accounting except that construction firms with under $10 million in annual gross receipts would still be able to use the method for contracts lasting less than two years. The Administration's proposal would apply the extended-period long-term contract cost allocation rules to all construction contracts.

House of Representatives' Proposal

The Ways and Means Committee, and subsequently the House of Representatives, approved tax legislation (H.R. 3838) which would repeal the completed contract method of accounting and require use of a modified percentage-of-completion method of accounting for long-term contracts entered into on or after September 25, 1985. Under the modified percentage-of-completion method, income would be reported during the life of the contract based upon estimated cost.

At the end of the contract, the actual income earned would be allocated to each year of the contract based upon actual costs, compared with the income reported under the percentage-of-completion method, and interest would be payable by, or to, the contractor on the yearly tax differences between reported income and allocated income (the lookback concept).

The House also adopted the Administration proposals which would apply the comprehensive cost capitalization rules now applicable to extended-period long-term contracts to all multi-year production, including long-term construction contracts.

However, in consideration of this legislation the Ways and Means Committee did recognize a number of the problems which these provisions would create in the construction industry. The House bill does exempt very small contractors, with average annual gross receipts of $10 million or less, from the new requirements and allows them to continue to use the completed contract method of accounting for contracts lasting less than two years.

The $10 million and two year provision does not go far enough. Many small contractors will be unable to use the completed contract method of accounting under the House proposal and as a result will face severe cash flow problems, will be unable to continue their current work level due to bonding problems, will be forced to furlough employees, and many will be forced to declare bankruptcy.

Administration's Proposal

The President's Tax Proposals for Fairness, Simplicity and Growth contain a proposal titled "Revised Rules for Production Costs" (Chapter 8.01) which would create a single set of capitalized costs for taxpayers performing long-term contracts, manufacturing inventories, self-constructing assets, growing crops and timber, and extracting minerals.

The Chapter proposes to implement the theory of 'tax neutrality' by applying the cost capitalization rules used for extended-period long-term contracts for tax accounting purposes to all of the multi-period activities just mentioned. The recommendation would have the effect of eliminating the construction contractor (less than $25 million in annual gross receipts) and construction contract (lasting less than 36 months) exemptions added to the Code by TEFRA. The Administration also recommended adding interest to the list of capitalized costs. Interest was proposed as a capitalized cost by the Treasury in 1982 and dropped by the Department from the proposal early in the legislative process.

The theory of tax neutrality assumes that the value of an asset must not be distorted by the tax system so that investment funds will flow freely. This theory may have some application for taxpayers who can either construct an asset themselves or contract out for its construction. However, the theory is not appropriate to apply to a taxpayer who happens to be in the business of building an asset which he never owns. For a contractor in the business of building, not owning, an asset the major policy consideration should be the accuracy and fairness of his reporting method. These policy considerations were incorporated in the 1976 final IRS regulations, confirmed statutorily by TEFRA in 1982 and should not be changed.

The shortcomings of the "neutrality" theory are evident when the major proposed changes in completed contract reporting are examined:

Excess Tax Depreciation

The 1976 IRS final regulations allow a contractor to deduct the excess tax depreciation over book amounts as a period cost. This rule places a contractor using the completed contract method of accounting in the same position as any other taxpayer using an accelerated depreciation method for equipment. Actual equipment cost for the contract is the book value which is treated as a capitalized contract cost. The amount of tax depreciation in excess of the book amount is deducted currently in recognition of the fact that this is not a contract cost. Depriving contractors of this deduction would inhibit the ability to reinvest in necessary capital equipment and continue to improve the industry's productivity.

General and Administrative Expenses

General and Administrative (G & A) expenses are by definition costs not allocable to any particular activity and represent the ongoing nature of the business. The extended-period contract rules requiring partial G & A allocations to contracts are extremely complex. Imposition of this rule on construction contracts lasting less than 36 months or on a contractor with less than $25 million in gross receipts cannot be logically justified. While abuses of this cost category may be possible in multi-tiered corporate structures when contracts of exceptional duration are performed, this rationale cannot be applied to small construction contractors or to construction contracts lasting less than 36 months.

Pension and Profit Sharing Plan Contributions

The 1976 regulations specifically provide for a current deduction for amounts contributed to pension and profit sharing plans. The regulations clearly reflect the Code's provisions which determine the timing of the deduction for employer contributions to such plans. The Code provides employers a deduction for the amount contributed to the plans when the contribution is made even though employees do not recognize income until retirement.

To qualify for this deduction the employer must have a written plan which establishes the employer's obligations to the plan. As the Administration proposals do not recommend any change regarding the timing of deductions for contributions to plans in general, and tax policy continues to encourage the creation and funding of such plans, the rule for such deductions under the completed contract method of accounting should not be changed.

Bidding Costs

The 1976 regulations properly recognize that costs incurred in bidding on contracts are not contract costs. While bidding expenses must be incurred to win a contract they cannot be considered contract costs because there is no contract when they are incurred. Although these costs are allocated to extended-period long-term contracts due to some exceptional contract durations (for example, 10-20 years), any extension of the rule to ordinary long-term contracts cannot be justified.

Interest Expenses

Interest expenses are treated as a current period cost deduction under the 1976 regulations. The Treasury Department voluntarily dropped a proposal to require the capitalization of interest in 1982, yet the new reform proposals again recommend the capitalization of interest.

Interest is a fungible commodity which is not allocable to any contract. Contractors generally borrow funds on the basis of an overall working capital loan. Funds are used on projects as required. For example, if an owner has not made a progress payment when supplies for a project are purchased, funds from working capital are used. The funds may be used for a short period until the progress payment is made. Borrowed funds may also be used on projects where progress payments have been made. Allocating interest expenses in any rational manner in these situations is virtually impossible.

Requiring capitalization of interest expense is also grossly unfair. Any interest income earned as a result of the contract is treated as ordinary income earned currently under the 1976 regulations. For example, if a contractor receives a progress payment which does not require immediate expenditure, he may deposit it in an interest-earning account. Interest income generated by the deposited funds is recognized by the contractor as income immediately. It is unfair to require the contractor to pay tax on interest income and at the same time capitalize interest expense.

Each of these proposed changes to the completed contract cost allocation rules for construction were reviewed and rejected by Congress in 1982. Unlike a taxpayer self-constructing an asset, growing crops or timber, extracting minerals, or manufacturing inventory items, a construction contractor does not own the asset being constructed. There is simply no justification for requiring the contractor's accounting method to reflect the depreciation basis of a constructed asset owned by the customer. The contractor is actively engaged in a business activity and his income reporting method should be based on the income generated by the business. The rules developed by the IRS in 1976 recognize the business activities of the contractor and the policies which should be applied in developing an adequate and fair reporting method.

Proforma Company Example -- Adverse Impact on Cash Flow

The Associated General Contractors of America has prepared with accounting assistance an illustration of the impact of the Administration Proposals on a relatively small construction company using the completed contract method. The example is based on actual construction company tax and financial information. Construction contracts performed by the example company include building and road contracts.

In addition to the completed contract method of accounting provisions, proposed changes involving depreciation, investment tax credits, ACRS benefit recapture and corporate rate changes have been factored in to estimate the increased tax liabilities the company would incur under Administration proposals.

The most significant change in the first year of the proposed changes results from the acceleration of tax payments under the revised accounting rules for the completed contract method of accounting. Under present law the company has a taxable income of $264,248 and a tax liability of $91,524. Changes to the completed contract method of accounting increase taxable income by $331,859 bringing taxable income to $596,107. Taxable income rises even further to $625,698 when other provisions of the proposals are included. This 126% increase in taxable income attributable to the proposed changes in the completed contract method will be ameliorated over time as contracts close. However, the firm's working capital will be permanently reduced by the value of the accelerated tax payments.

The components of the completed contract changes discussed in the preceding sections of this paper comprise the $331,859 increase in taxable income. The rule requiring general and administrative expenses to be allocated to contracts comprises 53 percent of the increase in taxable income, or $174,801. The elimination of the deduction for excess tax depreciation over book amounts results in 4 percent of the increase, or $14,503.

A different mix of equipment or a different ratio of equipment to contracts can significantly increase this category's impact. The change in the treatment of profit sharing plan contribution deductions results in 8 percent, or $27,711 of the increase. Capitalizing bidding expenses on awarded contracts results in $60,109, or 18 percent of the increase. The interest expense capitalization requirement results in $54,735 of the increase, 16 percent of the total.

The other changes in the Treasury proposal result in a $29,591 increase in taxable income. When these increases in taxable income are subjected to the proposed new tax rate schedule and the elimination of the investment tax credit is also taken into account, the construction firm's year-end tax liability would increase from $91,524 to $237,026. The percentage tax liability under the Administration proposal over present law translates into a 259 percent increase.

Bonding Capacity

Another example developed by the Associated General Contractors of America will illustrate the impact which these accounting and tax changes have on the bonding capacity, and therefore the ability to accept contracts, of a typical medium size construction firm. The same situation will apply to smaller firms as well.

COMPANY A

Company A has a deferred tax liability of $5 million, of which $2.5 million is payable at the end of its current fiscal year under the completed contract method. Company A also has a net worth of $6 million and working capital of $8 million. A bonding company considers net worth and working capital in determining the amount of work in progress it will permit Company A.

The bonding company also considers deferred taxes not to be paid in the current year as a reduction in current liabilities, thereby increasing working capital. In this instance, $2.5 million not due in the current year is deducted from current liabilities, increasing working capital by $2.5 million, from $8 million to $10.5 million. The bonding company will allow $20 of work in progress for each dollar of working capital. Under these circumstances, the bonding company will permit work in progress of $210 million ($10.5 million times 20). Under the percentage-of-completion method, however, Company A must pay an additional $2.5 million in income taxes, and the bonding company will in this case reduce the amount of work in progress allowed by approximately $50 million ($2.5 million times 20), or from $210 million to $160 million.

In a work program consisting of $210 million, work in progress, total operating revenue for a fiscal year would be in the range of $150 million. If the general contractor is doing 40 percent of the work with his own forces, the contractor would be employing approximately 800 employees. If the contractor's volume is thus reduced approximately 25 percent ($50 million divided by 210), then 200 of his 800 employees would become unemployed. Likewise, the approximately 1,200 subcontract employees would be reduced by 300 employees.

The reduction in the work force of the general contractor and of the subcontractor does not take into account the ripple effect on the hundreds of material and service suppliers to the general contractor and the subcontractor.

Conclusion

The completed contract method of accounting is the fairest and most equitable method of reporting income from long-term construction contracts because of the unique nature and inherent risks of construction. There is no justification for revising the present administrative rules for the method as they apply to the construction industry.

These rules were based on 58 years of IRS experience with the method when published in 1976 as final regulations and legislatively recognized by Congress in 1982. All current proposals to revise the use of the method in construction were reviewed in 1982 and rejected by either the Treasury or Congress as unworkable. They are contrary to sound tax policy and should be rejected once again.

Other Tax Reform Provisions

While the completed contract method of accounting proposals will have a serious adverse impact on individual construction firms, other tax reform provisions will severely harm both the industry and the nation's economy.

Cash Method of Accounting

The Administration proposal proposes to prohibit the use of the cash method of accounting with respect to a trade or business unless both of the following conditions are met:

(1) the business has average annual gross receipts of $5 million or less; and,

(2) no other method of accounting has been used to determine income, profit, or loss of the business for the purpose of reports or statements, or for credit purposes.

The House-passed legislation contains the same essential provision, but eliminates the restriction in (2) mentioned above, allowing additional firms to continue to use cash accounting. The House legislation also exempts certain professional service corporations and partnerships from the restrictions on cash accounting.

Although the completed contract method of accounting is the dominant method used in the construction industry, cash accounting is also used. For example, engineering and architectural contracts are not eligible for completed contract reporting. Small firms, (exceeding $5 million in annual receipts) use the method as an election for all accounting purposes.

The cash accounting method is a fundamental accounting method and a necessity. It is simply unfair to restrict its use and put taxpayers in a position where they must pay tax on income before they receive the cash benefit of that income.

Municipal Bonds

The President's report recommends the elimination of the tax-exempt status of interest earned on bonds issued by state and local governments for "private purposes". These bonds are typically used to finance housing, transportation, commercial and industrial development within the bond issuing jurisdiction. Municipal bonds would lose their tax-exempt status if more than 1 percent of their proceeds are used directly or indirectly by any person other than a state or local governemnt. An exception is provided if the facility is used by the general public.

Under the House-passed bill, nongovernmental bonds would no longer be tax-exempt if more than ten percent or $10 million of the proceeds are used by nongovernmental entities or five percent or $5 million are used to make loans to nongovernmental entities. Tax-exempt bonds would be eliminated entirely for irrigation facilities, district heating and cooling facilities, certain "air and water pollution control facilities," sports facilities, convention centers, and airport-related commercial facilities such as hotels and stores.

Tax-exempt bonds, however, could continue to be issued without being subject to the ten percent or five percent limitation for some "nongovernmental activities," including multifamily rental housing, airport facilities directly related to transportation, ports, mass transit, sewage and solid waste disposal, and water supply facilities. States that issue tax-exempt "nongovernmental bonds" would be subject to tight annual caps for such bonds equal to the greater of $200 million or $175 per capita. A portion of the aggregate limit would be reserved for mortgage bonds and use by non-profit organizations. Bonds for certain airport and port facilities would not be subject to such a cap.

Since January 1, 1986, the effective date specified in the House-passed bill as currently written, the municipal market has been essentially paralyzed by uncertainties surrounding the legislation. New issue volume for January saw the smallest number of new offerings in one month for the last 15 years.

The Associated General Contractors of America has done substantial research into the problems of this nation's deteriorating infrastructure of public facilities, as has the Congressional Budget Office, the Joint Economic Committee, and many other knowledgable organizations. All have concluded that the shortfall in infrastructure investment is at crisis proportions. With public spending coming under increasing budgetary pressures, revisions in the tax code which will further hinder the ability of state and local governments to find solutions to their infrastructure problems must be avoided.

Corporate and Personal Minimum Taxes

The Administration proposal included a tightened 20 percent Alternative Minimum Tax (AMT) on both corporations and individuals to replace the current add-on minimum tax. Of far more importance to the construction industry, the House-passed legislation contains an alternative minimum tax at a 25 percent rate with many additional preference items.

The most significant change in the House legislation is that the use of the completed contract method of accounting is not allowed for computation of the minimum tax. Instead, a taxpayer is required to apply the percentage-of-completion method in determining the minimum taxable income relating to a particular contract. The preference is calculated by substituting the minimum tax treatment for the regular tax treatment before calculating the minimum tax. In the House bill, this provision only applies to the small firms of under $10 million in gross receipts which were exempted from the repeal of the completed contract method of accounting.

The minimum tax proposal included in the House-passed legislation would greatly harm small firms without justification. Making the completed contract method of accounting a preference for purposes of the minimum tax takes away 70 percent of the usefulness of this method of accounting for construction companies subject to the minimum tax, according to an independent study by a major accounting firm. The completed contract method of accounting is a legitimate method of accounting, not a preference item, and its use should not be unfairly penalized by being made subject to the minimum tax. AGC strongly opposes this provision.

Accelerated Cost Recovery and Investment Tax Credits

The President's tax reform proposals recommend replacing the accelerated cost recovery system (ACRS) and investment tax credits (including credits applicable to real property improvements such as the rehabilitation and energy credits) with a new depreciation schedule called the capital cost recovery system (CCRS). The House-passed bill includes an incentive depreciation system, based on the old Asset Depreciation Range (ADR) mid-points, which would replace CCRS. Real estate under this system would be depreciated over 30 years, on a straight-line basis.

Under either of the proposed new depreciation systems, investors must wait a longer period to have their investment costs recognized by the tax system. The use of CCRS or the House's incentive depreciation system will have effects in other construction markets as well. Projects requiring extensive equipment installations will suffer more than those where the structure is the primary subject of the contract. The loss of the ITC will affect the cost of the equipment to be installed and is the difference between present law and the proposed changes. The proposed depreciation changes are expected to adversely influence investment decisions.

AGC's Proforma Co. example incorporates the changes to equipment depreciation and loss of the investment tax credit. While the Administration's proposal would increase the depreciation amounts for equipment by $3,418 (a benefit to the taxpayer), the loss of the investment tax credit increases the taxpayer's actual tax by $9,780. In addition, the benefit of acceleration would be curtailed by the change in accounting rules proposed for taxpayers electing the completed contract method of accounting by mistiming the deduction for the excess tax depreciation over book amounts.

Fringe Benefits

The President's report recommends including the first $10 per month and $25 per month of individual/family health plan coverage in an employee's gross income. The present $5,000 exclusion for employer provided death benefits would also be repealed. Uniform nondiscrimination rules are also proposed to cover a wide variety of employer provided benefits such as life insurance, health benefits, and educational assistance programs. New limits on contributions to cash deferred compensationplans would be imposed if individual retirement account contributions exceed certain levels.

The House of Representatives chose not to tax the health-related fringe benefits, and generally took a more sensible approach to the taxation of fringe benefits by recognizing the value of continuing present policies. AGC believes the policy of encouraging the creation of employer sponsored fringe benefit programs is better reflected by present law than the proposed Administration changes.

State and Local Tax Deductions

The President's proposals recommend that the deduction for state and local taxes not incurred in a trade or business be repealed. These taxes include state and local real and personal property taxes, income taxes and general sales taxes. The reason given for the proposal is to eliminate any "federal subsidy" for local public services such as public education, road construction and repair, and sanitary services.

The House-passed legislation retains the deductibility of state and local taxes. AGC believes the deduction for state and local taxes is based on sound tax policy considerations. AGC has great concern that the repeal of state and local tax deductibility will prevent necessary investment in state and local infrastructure.

Foreign Tax Credit

The original Treasury Department recommendation to impose a per country limitation on the foreign tax credit (FTC) is reproposed in the Administration's tax proposals. The carryover period is proposed to be extended from 5 to 10 years. No change in the FTC carryback period of 2 years is proposed, despite the explicit acknowledgement in the proposal that an extension is reasonable. In addition, new income "sourcing" rules are proposed in the President's report to deal with the foreign technical assistance tax problem found in international construction. A per-country election to either deduct (when there is no foreign income) or credit foreign taxes is also proposed.

The House-passed legislation would tighten rules for foreign-source income from current law, but modifies the Administration proposal. The House limited the amount of income "switching" which could be done from high-tax to low-tax countries.

U.S. contractors compete in countries where they are able to win contracts; the location of job sites cannot be chosen for tax planning purposes and any restrictions on offsets for taxes paid in countries where jobs are performed cannot be justified.

Limiting Travel and Expense Deductions

The Administration proposes treating travel assignments extending beyond one year as "indefinite", thereby denying any travel deduction for such job assignments. This proposal would reverse a recent IRS ruling which extended the possible time for "temporary" job assignments to two years under a variety of safeguards. These safeguards are requirements which are not applicable to the traditional test of a temporary assignment.

AGC believes the present IRS rules for determing whether a job assignment is temporary or indefinite reflect the business realities of the construction industry and should be maintained. Both management and labor construction personnel are required to travel to job sites. These sites are frequently long distances from employees' homes and assignments can be for substantial periods. These living expenses are incurred as a result of the employees' income generating activities and would not have been incurred absent the business necessity. The proposed rule would unfairly treat these expenses as personal when the employee is already paying the expenses of maintaining his real personal residence.

Possessions Tax Credit (Section 936)

The Administration's proposal adopts a Treasury Department recommendation that will dramatically affect construction activities in U.S. possessions, particularly in the Commonwealth of Puerto Rico . The House-passed legislation retains the credit while tightening the active trade or business test and cost-sharing rules.

The possessions tax credit (Section 936) has provided significant impetus to local economies in U.S. possessions. The substitute wage credit in the Administration proposal fails to compensate for the credit's repeal. AGC believes that repeal of the credit would have dramatically negative effects on construction activities in the U.S. possessions.

Capital Gains

The Administration's proposal to reduce the current capital gain exclusion from 60 to 50 percent is an improvement over the original Treasury Department recommendation to eliminate all capital gains. However, AGC is concerned about the restrictions on capital gain eligibility. Property used in an active business is not eligible for the exclusion unless the asset is land. These restrictions will prevent investors in limited partnerships from obtaining capital gain treatment on the sale of structures. Limited partners are owners of the property held by the partnership but do not have active management rights. This clearly distinguishes them from owners of active businesses.

The House-passed legislation would also reduce the current capital-gains exclusion from 60 to 50 percent in 1986, to a 42 percent exclusion thereafter, and would repeal the lower rate for corporations. AGC opposes these proposed changes in the tax treatment of capital gains, and believes that they will significantly harm capital formation.

At-Risk Limitations

The Code's at-risk rules have never been applied to investments in real property. Under current law investors in real estate syndications are allowed the full depreciation benefits of the cost of a structure without regard to the recourse liability of mortgage notes. Investors in personal property are subject to maximum depreciation amounts based on their personal liability under the at-risk rules.

This difference in treatment prevents valuation manipulations which can occur under a variety of situations in personal property investments. Such value manipulations are not applicable to real estate investments since they can be accurately valued. The imposition of the at-risk rules to investments in real property in the Administration proposal will require investors to assume liabilities which are not required for business ownership purposes and significantly reduce the attractiveness of investments in real property.

The House-passed legislation would include most of the Administration's proposal, but would exempt third-party financing. This is a major improvement over the Administration proposal.

Interest Expense Limitation

The President's Report proposes to limit all personal interest deductions, except for mortgage interest deductions for a personal residence, to $5,000 per year over investment income. Interest subject to the investment interest limitation includes: (a) all interest not incurred in connection with a trade or business, (b) the taxpayer's share of all interest expense of Subchapter S corporations unless the taxpayer actively participates in the corporation, and, (c) the taxpayer's distributive share of interest expense from limited partnerships.

The House-passed legislation would allow the deductibility of interest for both primary and secondary residences. This is a definite improvement over the Administration proposal, and AGC supports this modification.

Solid Waste/Mining Reclamation Costs

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. Cash method taxpapers deduct expenses when paid. Accrual method taxpayers accrue expenses when economic performance giving rise to the expense occur.

However, pursuant to a statutory exception to these general rules to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. These amounts are added to a reserve account. After reclamation activities are concluded actual costs are compared with reserve costs and any additional costs are deducted or excess reserve deductions added back to income. These special rules lower the cost of these special activities. The proposed repeal of this rule will result in a corresponding increase in costs and disincentive to invest in such needed activities.

Summary and Conclusion

- The current proposed changes to completed contract reporting for construction were fully reviewed by Congress and rejected during the legislative process preceding the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, and must again be rejected.

- The proposed tax "reform" provisions will harm the entire construction industry, but will have a disproportionately negative impact on small construction firms which are less equipped to comply with the administrative burden and financial liabilities associated with the minimum tax and completed contract provisions.

- Because of the beneficial ripple impact of construction throughout the entire economy, it is a certainty that any changes in tax laws that adversely impact the construction industry will surge throughout the entire economy with rippling adverse impacts on other industries that are dependent on the good health of the construction industry.

FAGIN, BROWN, BUSH, TINNEY, KISER & ROGERS
A PROFESSIONAL CORPORATION
ATTORNEYS & COUNSELORS AT LAW
SUITE [illegible] WEST
FIRST NATIONAL CENTER
OKLAHOMA CITY, OKLAHOMA 73102

TELEPHONE [illegible]
TELEPHONE [illegible]

January 30, 1986

U.S. Senator Don Nickles
United States Senate
Room 713
Hart Office Building
Washington, D.C. 20510

Re: Memorandum on 1985 Tax Reform Act

Dear Senator Nickles:

Enclosed for your information is a memorandum prepared by our firm regarding the proposed 1985 Tax Reform Act, H.R. 3838, currently pending in Congress, as it pertains to tax-exempt bonds, and its impact on economic development in Oklahoma if enacted in its present form.

We trust this memorandum will be helpful to you in assessing the impact of the Bill. If we may assist you in further analyzing the Bill, or provide any additional information, please contact us and we will assist in any way we can.

Respectfully submitted,

FAGIN, BROWN, BUSH, TINNEY, KISER & ROGERS

Lynn C. Rogers

Lynn C. Rogers
For the Firm

LCR:kg
Enclosure

FAGIN, BROWN, BUSH, TINNEY, KISER & ROGERS
A PROFESSIONAL CORPORTION
ATTORNEYS & COUNSELORS AT LAW
SUITE 1900 WEST
FIRST NATIONAL CENTER
OKLAHOMA CITY, OKLAHOMA 73102

TELEPHONE 405-235-3412
TELEPHONE 405-235-7436

January, 30 1986

MEMORANDUM

RE: Impact of the proposed Tax Reform Act of 1985 on economic recovery in Oklahoma

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INTRODUCTION

On December 17, 1985, the United States House of Representatives passed and sent to the Senate a bill, H.R. 3838 (the "Tax Reform Act of 1985" or the "Bill") which, if enacted by the Senate and approved by the President in its present form, will, among other things, alter or amend many of the provisions of Section 103 of the Internal Revenue Code regarding tax-exempt bonds issued by states and local governmental entities. The Bill, in its present form, has an effective date of January 1, 1986. This memorandum is intended to present a brief overview of the Bill as it pertains to tax-exempt bonds, and the impact of the pending Bill upon economic recovery efforts in Oklahoma.

For over two years, Oklahoma has been gripped by an economic recession. This slowdown in the State's economy has, to a great extent, been related to serious problems within the agriculture and oil industries. Strong efforts have been made to promote economic recovery within the State by encouraging other types of industry and commerce to locate or expand here, thus achieving a much-needed diversification of our economic base. At the same time, the State and its citizens have continued to do everything possible to help the recovery of agriculture and oil businesses.

A key element in Oklahoma's efforts to promote industrial development and economic recovery is the infusion of resources from outside the State. Industrial development authorities, mainly organized as public trusts acting on behalf of the State or local governmental agencies, have successfully utilized industrial development bonds ("IDB's") to induce new industries to locate within the State, or to encourage existing industries to expand. A large share of these bonds have been sold to out-of-state investors, resulting in a flow of capital into our economy from sources outside of the State. In addition to IDB's, State and local government entities have issued both general obligation ("G.O.") bonds and revenue bonds to finance much-needed expansion, repair and improvement of streets, libraries, schools, water and sewer systems and other public facilities to serve the continuing needs of our citizens, and at the same time, to further encourage the location or growth of new industry here.

The proposed Tax Reform Act of 1985, if enacted in its present form, would have a widespread, negative impact on the issuance of tax-exempt bonds of all kinds in Oklahoma, and on the continuing efforts of the Governor, the Legislature and many others to achieve economic recovery for the State. In particular, the January 1, 1986, effective date of the Bill is already stifling efforts to issue tax-exempt bonds in Oklahoma for worthy purposes.

THE BILL

If enacted in its present form, the Tax Reform Act of 1985, H.R. 3838, would make the following changes in the federal laws regulating the issuance of tax-exempt bonds by State and local governmental issuers and the purchase of these obligations by investors:

- Creates a distinction between

  "essential function bonds" and "nonessential function bonds" depending on the ultimate user of the bond proceeds.

  > A bond is a "nonessential function bond if:

    - 10% or more of its proceeds or $10 million, whichever is less, is used in the trade or business of a person other than a qualified governmental unit, or

    - 5% of its proceeds or $5 million, whichever is less, is used for a loan to such a person.

  > Thus, bonds traditionally used to finance a wide range of projects benefiting the public such as hospitals, airports, public transportation, waste disposal and multifamily rental housing would now become "nonessential function bonds".

- Provides that the exemption from federal income taxation does not apply to interest on "nonessential function bonds", except as further provided in the Bill.

- Provides that an exemption from federal income taxation will still apply to interest on certain types of "qualified nonessential function bonds"

  > These "qualified bonds" may include bonds for:

    - "exempt facilities", which include

      (i) airports ‡
      (ii) docks and wharves ‡
      (iii) mass commuting facilities ‡
      (iv) water facilities (other than irrigation) ‡
      (v) sewage disposal facilities
      (vi) solid waste disposal facilities
      (vii) qualified multifamily housing

      ‡ must be governmentally owned

- qualified single family mortgage revenue bonds
- certain "small issue" IDB's
- 501(c)(3) organization bonds, such as bonds issued for the benefit of hospitals, colleges and certain rental housing facilities
- qualified student loan bonds
- certain "redevelopment" projects under "tax increment" financing

> The Bill restricts those types of bonds that are "qualified bonds" in comparison to present law, particularly where the facilities acquired with bond proceeds are used or operated by the private sector.

- Total annual nongovernmental issuance in each state is subject to a volume cap of $175 per capita or $200 million, whichever is larger. Of this, $25 per capita, or $30 million, is reserved for nonprofit institutions - mostly hospitals and universities. Half of the remainder is reserved for housing and the other half for other nongovernmental financing. State legislatures are authorized, within limits, to reallocate financing authority under these caps among different purposes.

> Oklahoma's total allocation for all "nongovernmental" bonds under this formula is approximately $560 million, based upon a population of 3.2 million.

> Under present law, up to $150 per capita may be utilized annually for IDB's. For Oklahoma, this amounts to approximately $480 million for IDB's alone.

> Under present law, up to $200 million per year may be used for single family mortgage revenue bonds.

> Under present law, there are no limitations on the dollar volume of bonds that may be utilized each year by nonprofit institutions such as hospitals for qualified projects.

> Under present law, no dollar volume limit applies to the amount of bonds that may be used for multifamily rental housing.

- Increased restrictions are placed on bond programs for housing.

> In single family mortgage revenue bond programs, there are increased restrictions on annual family income of qualified borrowers, the acquisition cost of eligible residences, and the number of borrowers that must be first time homebuyers in both target and non-target areas.

  - In multifamily rental housing programs, there are increased restrictions on the use of bond proceeds for functionally related and subordinate facilities, the percentage of units held available for low income persons and the income of eligible tenants. In addition, there are increased reporting duties to prove compliance with low income set-aside requirements by the developer.

- New arbitrage regulations sharply curtail the ability of issuers to invest bond proceeds at yields materially higher than the bond yield and retain the earnings.

  - As a general proposition, all arbitrage earnings from investment of bond proceeds must now be rebated to the federal government.

  - These restrictions apply not only to IDB's, but also to "essential purpose bonds" where the governmental issuer is the owner and operator of the facilities financed with bond proceeds.

  - Limited exceptions apply:

    - In the case of "essential purpose bonds" such as general obligation or revenue bonds of governmental entities for schools, streets or utility system improvements, arbitrage profits may be retained if:

      (i) at least 5% of the proceeds are utilized for "bricks and mortar" within 30 days of issuance of the bonds; and

      (ii) all of the gross proceeds of the bonds are spent on the project within 6 months.

      Otherwise, arbitrage earnings must be rebated to the federal government.

    - Certain limited "temporary periods" still apply to reserve funds or debt service funds during which time arbitrage profits may be earned and retained.

- The Bill prohibits advance refundings of any issue of "nonessential function" bonds and sharply restricts the conditions under which "essential function" bonds may be advance refunded.

- Substantial changes are made in the way depreciation or cost recovery may be taken on property financed by "nonessential function" bonds by the tax-owner of the property.

- Top-bracket marginal individual and corporate tax rates are reduced, thus having the likely effect of lowering the demand for tax-exempt bonds.

- Taxpayers using tax-exempt "nonessential function" bonds as tax shelters will be subject to a stiff alternative minimum tax.

- Interest on tax-exempt bonds purchased by property/casualty insurance companies (one of the traditional high volume investors in tax-exempt bonds) will be subject to an increase in their effective tax rate.

- Commercial banks will not be allowed to deduct the cost of carrying tax-exempt bonds purchased after December 31, 1985.

- The Bill, in its present form, has an effective date of January 1, 1986, although nonbinding resolutions have been passed by both the House and the Senate expressing a preference for a later effective date.

THE EFFECT ON OKLAHOMA TAX-EXEMPT BONDS

The existence of the pending legislation is severely restricting issuance and delivery of most types of municipal bonds in Oklahoma, just as it is in the rest of the country. Recent articles from various financial publications, attached as Exhibits A, B and C, indicate the chilling effect the Bill, with its onerous provisions and uncertain effective date, has had on both the issuers and purchasers of tax-exempt bonds.

For example, within the past week, the offering of revenue bond issues of the Claremore Industrial and Redevelopment Authority and of the Latimer County Industrial Authority to finance construction of Veteran's nursing home facilities had to be suspended because of a general lack of market interest, attributed primarily to market uncertainty over the Bill and its effect on pending bond issues.

Even such "plain vanilla" bond issues as general obligation bonds of school districts or cities for such items as construction of classroom buildings or fire stations will be affected by the Bill.

Under the present language of H.R. 3838, in the section apparently intended to discourage the "early issuance" of bonds (according to the Staff Report of the House Ways and Means Committee), unless (i) at least 5% of the bond proceeds are expended for the governmental purpose of the borrowing within 30 days after the date the bonds are issued, and (ii) an amount equal to all bond proceeds (other than amounts invested in a reasonably required reserve or replacement fund) is expended for that purpose within 3 years of the date of issuance, then income from interest on the bonds will be taxable, retroactive to the date of issue.

The requirement that 5% of the gross bond proceeds be spent on "bricks and mortar" within 30 days of the closing of the bond issue is a particularly onerous one, especially in view of Oklahoma laws on competitive bidding of construction projects. Title 61 O.S. 1981 Section 104, a part of the Public Competitive Bidding Act of 1974, requires that a notice for bids on construction of improvements to real property must be published at least 20 days prior to the opening of bids. Section 111 provides that the contract must be awarded within 30 days of the opening of bids. Thereafter, the successful bidder is entitled to a reasonable time in which to execute the contract, provide the necessary surety bonds and proof of insurance, and commence work on the project, all in accordance with the provisions of the bid documents. After construction is commenced, the first progress payment may not be made to the contractor for 30 days or more.

Thus, in the normal course of events, 60 days or more may well elapse between the time notice for bids is published and payment of any amount is made to the contractor for project materials or labor costs. Assuming bids are not invited until bond proceeds are in hand, then it is obvious that 5% of the proceeds will not ordinarily be spent for tangible project improvements within 30 days of bond issuance, thus denying tax-exempt status to the bonds under the provisions of the Bill.

It may be theoretically possible for a local governmental unit to structure the bidding and awarding of a contract on a public construction project in a manner so as to comply technically with the Bill's requirements. However, the wisdom or practicality of such measures must be seriously questioned. If a school board or city council, for example, is willing to take a calculated risk and receive bids on a project prior to receipt of bond proceeds, providing in the bid documents that awarding of the contract to the successful bidder is contingent upon the closing of the bond issue and the delivery of bond proceeds, and further providing that work under the contract must proceed immediately and that the contractor must provide invoices evidencing that payment is due for at least 5% of the contract amount within 30 days of closing of the bond issue, then it might be possible to successfully comply with the requirements of the Bill, as well as applicable requirements of Oklahoma law on competitive bidding. But as previously mentioned, the wisdom and practicality of such a convoluted procedure is subject to serious question, and in some situations, issuers may be unable or unwilling to use such unconventional bidding procedures.

It is submitted that, unless the section of the Bill pertaining to the 5% requirement is amended, many construction projects for Oklahoma governmental entities cannot be financed with tax-exempt bonds, or if they are able to be financed, widespread and substantial changes in bidding procedures will be required.

This is but one example of the potentially damaging consequences of the Bill on Oklahoma issuers of tax-exempt bonds. Similar, and equally harmful, problems will be created for most issuers of revenue bonds to finance construction of utility improvements or to induce industrial development. If this were not enough, even in the limited instances where issuers are willing to proceed with the issuance of bonds, it is already clear that the January 1, 1986, effective date is seriously hampering efforts of Oklahoma issuers to market the securities and have the proceeds available for the needed projects.

An additional aspect of the Bill that further hampers the ability of municipal bond issues in Oklahoma to sell bonds for public improvement projects is the denial to banks of the ability to deduct the cost of "carrying" municipal bond portfolios.

Under Oklahoma law, commercial banks and other depositories of public monies are required to retain certain government obligations as security to collateralize these deposits. Traditionally, one of the primary sources of such collateral in Oklahoma has been general obligation bonds of school districts, municipalities, counties, or subdivisions of the State. However, it is sometimes necessary for a bank to borrow money with which to purchase and hold these securities, in order to remain eligible as a depository. Under present law, banks are permitted to deduct approximately 80% of the cost of "carrying" such securities as a business expense. Under the 1985 Tax Reform Act, this deduction is eliminated (with minor exceptions), making it costly and in some instances, unfeasible for banks to purchase or maintain large inventories of tax-exempt bonds.

Since commercial banks are and have been one of the primary markets for bonds of Oklahoma school districts and municipalities, the Bill's impact on the ability of such institutions to finance the purchase of local bonds is bound to have a significant effect on the ability of the issuers to sell their bonds, and when sold, on the interest rate. We must not lose sight of the fact that any increase in interest rate on bonds of such local issuers will be directly borne by the tax payers and residents of the school district or municipality. Thus, the local tax payer or utility rate payer in Oklahoma will, in effect, be penalized for the federal government's denial of this legitimate business deduction to banking institutions.

WHAT WE CAN DO ABOUT IT

The United States Senate has not yet taken action on the Bill. Obviously, then, one of the most important actions to be taken is for persons concerned about the impact of the Bill to write Senators Boren and Nickles, as well as Senators from other states, expressing opposition to the Bill in its present form, and urging amendments to allow State and local governments some breathing room.

In particular, it is urgent that efforts be made to modify or eliminate at least these three portions of the Bill: (1) the 5% - 30 day expenditure test for bond proceeds; (2) the denial of deductibility of carrying costs to banks as purchasers of tax-exempt bonds; and (3) the January 1, 1986 effective date.

The addresses and telephone numbers of Oklahoma's United States Senators and Representatives are included in the attachment at the end of this memorandum.

The participation of all concerned in expressing to our congressional delegation our alarm over the potential impact of the Bill is vitally needed. If Oklahoma is to successfully continue its efforts to encourage economic development and maintain or increase the level of local government services, we must act without delay in doing everything we can to eliminate or modify these harmful provisions of the Bill.

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